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TAXATION OF DERIVATIVE TRANSACTIONS

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by C. Anne Calverley, Jehad Haymour and Sophie Virji,[1] Dentons Canada LLP

Futures, swaps, European, Asian, American, Bermuda, knock-in, knock-out, look-back, rainbow, quanto, basket options, cover or uncovered. Some of the above may be mistaken for selections you will find at a grocery store, rather than derivative contracts that can be tailored by parties to meet specific and important needs. While the types of derivatives may be seen as complicated, varied and intricate, the law governing the taxation of derivatives is relatively straight forward and well-developed, and has been consistently applied.

Before discussing the taxability of derivative contracts ("derivatives"), it may be beneficial to provide some background on derivatives. First, it is worth mentioning that a pithy definition for derivative contracts is somewhat elusive. The most common definition describes a derivative contract as a contract that derives its value from something else, be it an underlying property, a reference rate or an index.[2]

Derivatives commonly fall into two categories, forward contracts and options, with the difference between the two being whether the obligations of the parties are mutual or unilateral at the time that the parties entered into the relevant derivative. The parties to a forward contract have mutual obligations, requiring both parties to perform under the contract. By contrast, under an option, the obligation is unilateral in that the counterparty to the option only becomes obligated to perform under the derivative after the option holder exercises its option.

Furthermore, derivatives are used for numerous purposes. The two primary reasons that derivatives are entered into are (i) to speculate in respect of the value of a commodity, rate or index or (ii) to mitigate financial risk. Derivatives are generally used in the corporate sector to reduce the impact of market volatility in respect of commodity prices, interest rates, exchange rates, and other factors that are subject to market fluctuations.

The most common derivatives are over the counter derivatives that are entered into utilizing International Swap Dealers Association Inc. Master Agreements ("Master Agreement"), with the specific derivative transactions being entered into by way of confirmation tickets ("confirmations"), which form part of the Master Agreement.

The Master Agreement sets out the global terms under which the parties agree to contract, including, among other things, the obligations of the parties, representations and covenants, events of default and termination events. Each transaction under the Master Agreement as evidenced by a confirmation is governed by the terms of the Master Agreement and the confirmation sets out the economics of the particular derivative transaction and the timing for close out of the derivative. By entering into a Master Agreement and the confirmations made under that Master Agreement, a party and the counterparty are also each exposing themselves to risk under the confirmations that must be managed. Although each confirmation is a contract in its own right, all of the confirmations made

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under the Master Agreement are considered to form a single transaction and must be collectively considered for the purpose of ascertaining the total obligations and risk assumed by each party.

Given that each confirmation represents a win-loss transaction, there is the ongoing potential for a party to be unable to fulfill its financial obligations under the derivatives. A corporation entering into a derivative will want to know that the counterparty can meet its financial obligations on close out of the derivative/confirmation. The counterparty is similarly concerned with the corporation's ability to satisfy its obligations arising under the confirmations and the Master Agreement. The Master Agreement accordingly incorporates credit controls needed to deal with this credit risk including establishing guidelines for ongoing credit support that is required to be given by a party and the triggering of events of default or termination. Accordingly, particular attention is paid to defining the parties to the Master Agreement, involvement of other parties and the credit support that each must give.

In considering the taxability of a derivative, it is important to note that although a derivative may derive its value by reference to another property, this reference does not detract from the derivative's separate existence. A derivative transaction is a separate transaction that gives rise to a gain or loss in its own right, regardless of what it derives its value from.

Furthermore, regardless of the reason for entering into a derivative transaction, the taxpayer's motive will not be determinative of the tax treatment. There is unavoidable speculation in every derivative transaction regardless of motive, with each derivative being a win/loss transaction that will result in the realization of income or loss to the respective parties. Accordingly, the reason that a taxpayer enters into a derivative contract, whether for speculation or to mitigate risk, is ultimately not determinative of its tax treatment. Instead, as discussed below, the tax treatment afforded to a derivative gain or loss will be determined by reference to the underlying transaction, if any, to which the derivative relates.

This paper will explore the law relating to the taxation of derivatives in Canada. We will then discuss the recent and novel approach to taxation of derivative transactions taken by Canadian tax authorities, which involves applying transfer pricing concepts, and the problems with such an approach.

Part A: Tax Treatment of a Gain or Loss on a Derivative Transaction

Characterization

Historically, the issue that the courts were most frequently asked to address as it pertained to the taxation of derivatives was whether the gain or loss from the derivative was realized on capital account or on income account. As analyzed further below, this issue will be determined on the basis of: (1) whether the derivative is linked to an underlying transaction (the "linkage principle"), and (2) whether that underlying transaction to which the derivative is linked, if any, is a capital or income transaction.

Although the linkage principle was not specifically referred to as such in early jurisprudence, the concept has been consistently applied over time to the taxation of gains and losses arising from derivative transactions. As the name suggests, the linkage principle links the tax treatment of a derivative gain or loss to the underlying transaction to which it relates. If the underlying transaction to which the derivative is linked relates to the investment of idle capital funds of the taxpayer, the borrowing of long term capital, or the proposed disposition of a capital asset by the taxpayer, the

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resulting gain or loss will be on capital account. If the underlying transaction to which the derivative is linked relates to an income transaction made in the ordinary course of the taxpayer's business, the resulting gain or loss will be on income account. Finally, if there is no underlying transaction to which the derivative is linked, the derivative will be treated as being speculative, and the resulting gain or loss will be on income account. Thus linkage, rather than motive, will be determinative of the tax consequences of a derivative transaction.

Like other dispositions, if the gain or loss is on income account, such gain or loss is fully included into the taxpayer's income, while capital gain/loss treatment is afforded to a derivative gain or loss that is on capital account.

Jurisprudence on Linkage

The law relating to the taxation of derivatives is well-settled due to the extensive jurisprudence. The principles governing taxation, specifically the linkage principle, can be traced back to one of the first and leading cases in this area, *Atlantic Sugar Refineries Limited v. MNR*.[3] In that case, the taxpayer engaged in purchasing and refining raw sugar and was in the business of the sale of refined sugar. At the request of the Canadian government during war time conditions, the taxpayer purchased more raw sugar than it normally would. Anticipating a decline in sugar prices, the taxpayer hedged its exposure by entering into a forward sale of raw sugar (regardless of the fact that it did not intend to sell raw sugar). Once prices declined, the taxpayer realized a gain on the forward sale.

The Court was asked to determine whether the gain was on income account or on capital account. The taxpayer sought to have the gain characterized as being on capital account on the basis that it arose outside of the scope of its ordinary business and outside of its income from business operations. The taxpayer argued that its activities in trading on a commodity exchange could not be characterized as part of its business operations as it had previously entered into the futures transaction on only two occasions. Further, it argued that such trading could not be considered a hedge in respect of inventory as the forward sales were made over the period of a month following the purchase of raw sugar and therefore did not synchronize with the purchase of a business commodity (i.e., the raw sugar). In considering this hedging argument, the Court stated:

> 12. …I think that this circumstance does not affect the matter to be determined. While not carried out contemporaneously with the purchases, the short sales were in effect a hedge by the company against a possible loss on the purchases made and it was only the imposition of control on October 2nd [by government under the *War Measures Act*] that rendered further hedging operations inadvisable. In trades where natural products are purchased in large quantities, hedging is a common, and in some cases, a necessary practice, and the cost of such operations in trades of this nature is properly allowable as an operating expense of the business. Where, as in the present case, the trader elects to close out his short sales and take a profit, this is, in my opinion, properly classified as profit from carrying on the trade...[4]
>
> The Court then distinguished this transaction undertaken from one that is capital in nature, stating as follows:
>
> 8. The Company was not investing idle capital funds nor was it disposing of a capital asset. In no sense may it be said that the operations were unconnected with the appellant's business and it is at least an added circumstance that the speculation was made in raw sugar. Even if it were the only transaction of that character, it should be

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> held, in the light of all the evidence, that it was part of the appellant's business or calling and therefore a profit from its business within section 3 of the Act.[5]

Although the Court did not adopt the term "linkage", it adopted the concept of linkage. The taxpayer entered into a derivative transaction which related to its business and specifically related to its inventory. It was not linked to a capital asset. Accordingly, the derivative was viewed as linked to the business and the gain was considered to have arisen in the ordinary course of the taxpayer's business and was, therefore, on income account.

Similar approaches were taken in *Dominion Steel and Coal Corp. Ltd. v. Minister of National Revenue*[6] and in *Minister of National Revenue v. Tip Top Tailors Ltd.*[7]

In *Dominion Steel*, the taxpayer was in the business of shipping goods to the United Kingdom (the "UK"), with payment being received in pounds sterling. In an attempt to mitigate losses relating to the conversion of pounds sterling into Canadian dollars, the taxpayer sold pounds sterling futures in the UK. When the exchange rate declined, the taxpayer realized a gain in respect of the pounds sterling futures. The Tax Appeal Board held that the gain should be taxed on income account as the exchange of pounds sterling for Canadian dollars was part of the taxpayer's normal business and thus the gain on the sterling futures was incidental to that business.

In *Tip Top,* the taxpayer purchased large quantities of clothing and other supplies in the UK in pounds sterling. Payment for such purchases was made through the London branch of a Canadian bank using either funds on deposit or the taxpayer's pounds sterling line of credit. In contemplation of the devaluation of the pound sterling, the taxpayer took a significant draw down on its line of credit. Upon devaluation of the pound sterling, the taxpayer purchased pounds sterling at a reduced rate, repaid the line of credit and realized a corresponding gain. In concluding that the gain should be taxed on income account, the Supreme Court of Canada held that the line of credit was not a temporary investment in foreign currency but was instead an accumulation of debt used for the taxpayer's trading operations. The purchase of pounds sterling was determined to be part of those commercial operations of the taxpayer, namely part of the purchase of supplies in a foreign currency, and thus taxable on income account.

While neither of the above cases included an express discussion of the linkage principle, the concept of linkage was applied. In both cases, it was found that the derivatives were linked to the taxpayer's daily business operations, entered into to manage business risk, and were not linked to any capital asset.

The first express statement of the linkage principle appeared in the decision in *Salada Foods Ltd. v. R.*[8] In that case, the taxpayer entered into a forward sale of pounds sterling in anticipation of a decline in the value of that currency. The taxpayer argued that its intentions were to hedge against the possible decline in value of its UK subsidiaries. Subsequently, the pound sterling did decline in value, resulting in a gain on the taxpayer's forward sale.

The taxpayer argued that the gain realized on its forward sale should be viewed as being on capital account on the basis that the purpose of the forward sale was to protect its "investment" in its UK subsidiaries. Such investment included money owed to the taxpayer by its subsidiaries for services rendered, intercompany loans and undistributed profits. The Crown conceded that the forward sale transaction was not made in the ordinary course of the taxpayer's business or trade but argued that the transaction was an adventure in the nature of trade.

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In concluding that the currency derivative was not in respect of the taxpayer's "investment" in its UK subsidiaries, but was rather realized on income account, the Court stated as follows:

> 16. …it seems to me that there is little or no relationship between the gain received by the plaintiff on its forward sale contract and its actual investment loss occurring as a result of the devaluation of the pound. To that extent then, in my view, the evidence of the witness and the arguments advanced by counsel for the plaintiff in support of the propositions that the gain was offset by the loss in investment and was attributable to capital account and not income tend to be specious and cannot be supported by other evidence nor withstand close scrutiny as to the result achieved by the transaction in question.[9]

The Court made the following additional observations in support of its conclusion that the gain was realized on income account (and not on capital account):[10]

1. the taxpayer acted in the same manner as a dealer;

2. the taxpayer was familiar with the financial markets and entered into the forward transaction as a normal part of its business;

3. the taxpayer was not investing idle capital funds nor was it disposing of a capital asset;

4. there was no accord between the notional principal amount of the forward sale and the value of the UK subsidiaries that it was purportedly trying to hedge the risk in respect of;

5. the underlying UK subsidiary (i.e., the asset) may never be disposed of and the purported offsetting loss may never be realized; and

6. there was an absence of evidence with respect to the company's intention to link the forward sale transaction to the value of the UK subsidiaries.

In respect of the undistributed earnings held in the UK subsidiaries, the Court commented that those amounts could in no way constitute part of the taxpayer's investment as the distribution of amounts from the subsidiaries was wholly in the hands of the directors of the subsidiaries. The Court concluded that there was little or no relationship between the gain on the currency derivative and the value erosion of the subsidiary relating to the currency devaluation and held that the transaction was purely speculative, entered into with the hope of realizing a profit, and thus an adventure in the nature of trade taxable on income account.[11]

On the issue of the taxpayer's motive, the Court commented:

> 21. …does the fact that the plaintiff has stated that the purpose of the transaction was to protect and preserve one of its capital assets, namely its investment in its UK subsidiaries, affect in any way this determination? In my opinion, the short answer is that it does not...
>
> …

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> 23. …Having found that the income was from an adventure in the nature of trade on the above authorities, it is immaterial what the motive was that brought the profit into existence and how it was applied thereafter.[12]

Applying the principles developed in *Atlantic Sugar* and the subsequent cases, the Court in *Salada Foods* expressly identified the requirement that there must be a "relationship" (or linkage) between a derivative transaction and an underlying transaction for a gain or loss to be considered as being on capital account. In the absence of any such linkage, any related gain or loss will be considered as having been realized on income account.

Applying this linkage principle, the same conclusion was reached in the case of *Ethicon Sutures Ltd.* v. *R.*[13] In that case, the taxpayer, a wholly-owned subsidiary of a corporation formed in the United States ("US"), manufactured and distributed surgical sutures and instruments in Canada. The taxpayer was required to pay a percentage of its net income to its parent company in the form of dividends on a quarterly basis. In the relevant years, the taxpayer was required to have funds available at all times to pay such dividends in US currency and accordingly converted its excess funds into US dollars and invested in short-term US deposit notes of major Canadian banks. At issue was the characterization of gains realized on foreign exchange transactions the taxpayer entered into to mitigate its foreign exchange exposure related to the conversion of its excess funds into US currency. The taxpayer contended that the converted excess funds were held not only for dividends, but also for capital expenditures, and as such, any related gain should be on account of capital.

On the issue of linkage, the Tax Court of Canada commented:

> 25. The determining factor in a case such as this, as in most cases which one is required to distinguish as to whether the transaction is on account of income or capital, is the intention with which the foreign currency is originally bought; if it is to carry out an intended commercial transaction in the normal course of the business then any profit, however arising, made on disposal of the foreign currency is of a revenue nature and taxable (Hannan and Farnsworth, *The Principles of Income Tax*, p 46; *vide Imperial Tobacco Co (of Great Britain and Ireland) Ltd v. Kelly*, [1943] 2 All ER 119, 431).[14]

The Tax Court concluded that the gain should therefore be taxed on account of income and held that it could not be said that the surplus funds were specifically set aside for the payment of dividends to the taxpayer's parent corporation, capital expenditures, the purchase of inventory or the payment of salaries. Rather, the funds set aside were not dedicated for particular use and any gain from the derivative was therefore realized in the ordinary course of that business.

On appeal, the Federal Court-Trial Division adopted the following principles of broad application to financial derivative transactions:

> 24. To determine whether a foreign exchange gain is to be treated as income or capital, it is necessary to look at the nature of the underlying transaction which gives rise to the gain.
>
> 25. Where the foreign currency was acquired as a result of the taxpayer's trading operations, or for the purpose of carrying on trading operations, any gains will be treated as occurring in the course of the taxpayer's trade and will be treated as income.
> …

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> 26. Likewise, where the transaction is a speculation made in the hope of profit, it will be treated as an adventure in the nature of trade, and the gain will be taxed as income…
>
> 27. However, if the gain arises out of the investment of idle funds or the appreciation of a temporary investment, the gain will be treated as a capital gain...
> …
>
> 34. To be considered capital in nature, the funds must be surplus, must be exclusively for dividend or capital expenditures, i.e., it must be a firm final dedication, and not enough if "earmarked primarily".[15]

The above statements are consistent with the approach adopted in earlier jurisprudence and are consistent with the subsequent views of the Supreme Court of Canada in *Shell Canada Limited v. R.*,[16] as discussed below. *Ethicon Sutures* aptly describes the linkage principle. In order to properly characterize a gain or loss arising from a derivative, the question to consider is whether the derivative is in respect of an underlying transaction that is exclusively the sale of a capital asset, the repayment of a debt, or the investment of idle capital funds, or, alternatively, whether the underlying transaction relates to business operations. Where a derivative instrument is not funded with idle/surplus capital funds or earmarked exclusively for capital purposes, any related gain or loss will be considered to be realized on income account. In such circumstances, the taxpayer will be viewed as either speculating or acting in the course of its trade or business.

This approach to derivatives was confirmed in *Echo Bay Mines Ltd. v. Canada*[17] wherein the Court dealt with the concept of the linkage principle in respect of a hedge transaction (i.e., linked to commodity production). In that case, the taxpayer operated a silver mine in Canada. In order to assure fixed prices for future silver production, the taxpayer entered into forward sales, negotiated by the taxpayer's US parent on its behalf, designed to hedge market fluctuations in the price of silver. No amounts of silver were ultimately delivered under the forward sales contracts and they were closed out or rolled over when they became due.

The taxpayer treated the income from the settlement of forward sales contracts for delivery of silver as forming part of "resource profits" under the *Income Tax Act* (Canada) (the "Act") for the purpose of calculating the resource allowance deduction. At issue was whether the gains from the derivative contracts were sufficiently linked to the production and sale of silver so as to qualify for inclusion in taxpayer's "resource profits".

The Court stated that the following criteria are required for a forward contract to be considered a hedge, rather than a speculative transaction:

> 1. The item to be hedged exposes the enterprise to price (or interest rate) risk.
>
> 2. The futures contract reduces that exposure and is designated as a hedge.
>
> 3. The significant characteristics and expected terms of the anticipated transactions are identified.
>
> 4. It is probable that the anticipated transaction will occur.[18]

The Court went on to state:

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> 21. …the difference between hedging and speculating is that in the former the company engaged in hedging sells forward or commits a product it has the capability of producing and that it intends to produce: if it has neither the capability nor the intention of meeting its commitments through production it is speculating in engaging in forward sales contracts.
>
> 22. Whether a transaction is a hedge depends upon assessment at the time forward sales contracts are concluded of capacity and intention to produce product committed under those contracts. Where the transaction is a hedge, profits realized on settlement of the contracts are considered a component of the price realized for the product when sold and under accounting practice are included in income from sales...[19]

The Court ultimately held that a hedge existed as the forward sales contracts were owned by the taxpayer, the contracts fixed the price of future silver production and the hedged volumes did not exceed the taxpayer's anticipated silver production. The Court observed that the requirements for the transaction to qualify as a hedge were met because the forward sales transactions were in respect of the same commodity as the taxpayer's production and were integral to the taxpayer's silver producing business. As such the gains on the forward sales contracts were held to qualify as "resource profits".

Another case dealing with the concept of hedging and linkage is *Placer Dome Canada Ltd. v. Ontario (Minister of Finance)*,[20] but this case involved an interpretation of the term "hedging" under the *Mining Tax Act* (Ontario).[21] In that case, the taxpayer was one of many wholly-owned subsidiaries of Placer Dome International ("PDI"), a group of companies involved in the exploration, production and sale of gold worldwide. PDI entered into certain derivative transactions on behalf of, and as agent for, its subsidiaries, including the taxpayer, the purpose of which was to protect the worldwide output of the group of companies from fluctuations in the spot price of gold. The derivative contracts were ultimately closed out, without the physical delivery of gold, and a gain was realized by the taxpayer.

The Supreme Court of Canada was asked to consider whether the entering into of derivative contracts by the taxpayer was hedging within the meaning of the *Mining Tax Act* (Ontario) thus qualifying the gain for inclusion in the taxpayer's profits for the relevant years. The Court distinguished a hedge from a speculative transaction as follows:

> 29. …A transaction is a hedge where the party to it genuinely has assets or liabilities exposed to market fluctuations, while speculation is "the degree to which a hedger engages in derivatives transactions with a notional value in excess of its actual risk exposure": see B. W. Kraus, "The Use and Regulation of Derivative Financial Products in Canada" (1999), *9 W.R.L.S.I. 31*, at p. 38…[22]

As the amount of gold committed to the derivative transactions did not exceed the actual production from the respective mines, the Court found that the transactions were not speculative in nature, but rather related to the business of the taxpayer. Moreover, the fact that the derivative contracts were closed out without physical delivery taking place was not determinative of the issue. The Court drew on the findings in *Echo Bay Mines* in coming to this conclusion:

> 34. The decision in *Echo Bay Mines* illustrates the way in which financial transactions, though they may not be settled by physical delivery of the output of an Ontario mine, may nevertheless be said to "fix the price" for that output...[23]

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The Supreme Court discussed the principles of hedging established in *Echo Bay Mines*, but ultimately determined the hedging issue by specific reference to the statutory definition of "hedging" contained in the *Mining Tax Act,* which definition included "…certain non-speculative transactions which fix the ultimate price of mine output, even if such transactions did not result in the physical delivery of output".[24] On this basis, the Court included the derivative gain in the taxpayer's profits for the relevant years.

While the courts in *Echo Bay Mines* and *Placer Dome* dealt specifically with the meaning of "hedge" or "hedging" in their analysis of linkage to an underlying transaction, the concept of fixing the price of output for the purpose of characterizing a derivative transaction is not a new concept. Referring back to the Supreme Court of Canada's analysis in *Atlantic Sugar,* the Court applied this concept, linking the forward contract in respect of raw sugar to the taxpayer's sugar inventory. In that case, the Court recognized that "…the short sales were in effect a hedge by the company against a possible loss on the purchases made…"[25] and that the entering into of sugar futures to offset the risk relating to the sugar inventory was "…part of the [taxpayer's] business or calling and therefore a profit from its business…".[26]

In *Shell Canada Limited v. R.,*[27] the Court considered the linkage of foreign exchange contracts to the taxpayer's funding of long term working capital. In that case, the taxpayer borrowed money by issuing debentures denominated in New Zealand dollars and converted those funds to US dollars to meet working capital requirements for the ensuing five-year period. The taxpayer also entered into US dollar/New Zealand dollar foreign exchange contracts to fix its cost of purchasing New Zealand dollars to meet its future repayment obligations. The Supreme Court of Canada was asked to consider whether the gain on the foreign exchange contracts should be taxable on income or on capital account. The Court confirmed that the gain should be characterized having regard to the underlying debt obligation (i.e., the transaction) to which the foreign exchange contract related and stated as follows:

> The characterization of a foreign exchange gain or loss generally follows the characterization of the underlying transaction … Thus, if the underlying transaction was entered into for the purpose of acquiring funds to be used for capital purposes, any foreign exchange gain or loss in respect of that transaction will also be on capital account.[28]

As the underlying purpose of the derivative contract was capital in nature, relating to the repayment of the five-year debentures in New Zealand dollars, the foreign exchange gain was found to be on capital account.

The above jurisprudence provides a consistent approach taken by the courts in respect of the taxation of derivatives. A derivative linked to a capital transaction, sale of an asset, investment of idle funds or earmarked exclusively for capital purposes will be on capital account. The gain or loss on a derivative linked to the ordinary business of the taxpayer will be on income account. Also, a gain or loss on a derivative that is not linked to an underlying transaction will be considered to be speculative in nature and will thus also be on income account.

Canada Revenue Agency Administrative Positions on Linkage

Like the consistent approach taken by the case law in this area, Canada Revenue Agency's ("CRA") administrative positions on the treatment to be afforded to a gain or loss on a derivative have mirrored the jurisprudence in this area.[29] CRA's administrative position in respect of whether commodity

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derivatives will attract income or capital gains treatment is summarized in Information Bulletin IT-346R, which provides as follows:

> 3. For taxpayers who take futures positions in, or who have transactions in, commodities connected with their business as part of their business operations, the trading in such futures or commodities creates fully taxable profits and fully allowable losses on account of income (hereinafter called "income treatment")…
>
> 4. Also accorded income treatment for tax purposes are transactions in commodity futures or commodities by taxpayers who, while not carrying on business that utilizes a particular commodity, have access to special (insider) information about the commodity which they use to their benefit in one or more such transactions. For example, a senior officer of a sugar refinery who personally enters into transactions in sugar futures or sugar is included in this category.
>
> 5. Corporate taxpayers whose prime or only business activity is trading in items to which the comments in this bulletin apply are subject to the income treatment.
>
> …
>
> 10. As a general rule, a taxpayer who takes commodity futures positions in, or who has transactions in, a commodity connected with a business, is considered to be trading as part of the business operations....[30]

CRA has published numerous administrative positions that have considered the characterization of gains and losses from derivatives entered into to manage foreign exchange exposure relating to the net asset value of foreign subsidiaries of Canadian corporations or of Canadian subsidiaries and/or foreign subsidiaries that adopted functional reporting in a foreign currency.[31] In each of those administrative positions, CRA has concluded that related derivative gains and losses should be treated as being on income account. For instance, in CRA Document No. 2009-0352061I7, CRA stated:

> …it is CRA's position that in order for a forward contract to be a hedge for income tax purposes, the forward contract needs to be linked to a transaction (e.g., sale, repayment of debt), not an asset or liability. The CRA's long-standing position … is that the characterization of gains or losses as on account of income or capital from a forward contract that was a hedging instrument depended on the underlying use of the funds that the forward was designed to hedge. The forward contract intended as a hedge would be considered separately from the underlying transaction that is being hedged, although its nature is characterized by the underlying transaction.
>
> …
>
> The courts (*Echo Bay Mines Ltd. v. The Queen*, 92 DTC 6437, *Salada Foods Ltd. v. The Queen*, 74 DTC 6171, *Ontario (Minister of Finance) v. Placer Dome Canada Limited*, 2006 SCC 20) have confirmed that whether an activity constitutes hedging depends on sufficient inter-connection or integration with the underlying transaction.
>
> …
>
> …the courts have held that for financial instruments to constitute a hedge there must be sufficient linkage with the underlying transaction. Where there was sufficient linkage

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> between the financial instrument that is used as a hedge and the particular asset or liability underlying a transaction, the character of the financial instrument (hedging item) would follow the character of the hedged asset or liability (hedged item). [32]

In CRA Document No. 2009-0345921I7 (and CRA Document No. 2010-0355871I7), the CRA observed that a hedge transaction may only be undertaken in respect of property that is owned by a taxpayer, stating as follows:

> In [CRA's] view, the legal entity should have a direct ownership of the underlying hedged item. From a separate legal entity perspective, the legal entity should have an underlying transaction exposed to foreign exchange rate fluctuations, otherwise, there is no offsetting position against which any of the gains and losses arising from the hedges could be matched. In [CRA's] view, if there is no linkage between the foreign currency contracts entered into by the legal entity and an actual or intended sale of foreign currency denominated capital assets, the foreign currency contracts do not constitute a hedge of a capital item for income tax purposes.[33]

In CRA Document No. 2010-0367611I7, CRA reiterated some of the principles that it adopted in the earlier CRA administrative positions referred to above and stated:

> In circumstances where a foreign currency borrowing is hedged with a foreign currency swap, the offsetting gain and loss on the receipt of the principal swap and repayment of the foreign currency loan will be treated on a consistent basis; and that is either both capital or both income. Notwithstanding the foregoing comments, in the event that the swap and the foreign currency loan are, or become, "unmatched", the tax consequences will be re-examined. In the case at hand, the loan and the foreign currency swap are of the same amount, can be matched, and relate to the payment of a dividend. Accordingly, in our view, the loss from the swap transaction should be on capital account.
>
> The principles that have evolved under case law with respect to distinguishing whether a foreign exchange gain or loss is on income or capital account were summarized in *Ethicon Sutures Ltd. v. The Queen*, [1985] 2 C.T.C. 6, 85 DTC 5290, as follows:
>
> > • To determine whether a foreign exchange gain is to be treated as income or capital, it is necessary to look at the underlying transaction that gave rise to the gain or loss.
> >
> > • If the foreign currency was acquired as a result of the taxpayer's trading operations or for the purpose of carrying on trading operations, any gains will be treated as occurring in the course of the taxpayer's trade and will be on income account.
> >
> > • If the transaction is speculation made in the hope of profit, it will be treated as an adventure in the nature of trade and the gain will be taxed as income.
> >
> > • If the gain arises out of the investment of idle funds or the appreciation of a temporary investment, the gain will be treated as a capital gain.

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• To be considered capital in nature, the funds must be surplus and must be exclusively for dividend or capital expenditures (i.e., "earmarked primarily" is not enough).[34]

In CRA Document No. 2011-0418541I7, the CRA Rulings Directorate ("CRA Rulings") was asked to opine on whether certain commodity derivative contracts were deductible by the Canadian taxpayer on income account and the application of the prior CRA administrative positions. The CRA Audit Division ("CRA Audit") referred the question to CRA Rulings and asked CRA Rulings advice as to whether certain gains and losses from derivative contracts should be treated as being on income account, given that the contracts were treated for financial statement purposes as relating to a hedge of a foreign affiliate's mining production.

CRA Rulings summarized the prior CRA administrative positions on capital versus income treatment of derivative contracts and noted:

> As you noted in your referral, there have been numerous Income Tax Rulings documents written in the recent past on the subject of capital vs. income treatment of derivative contracts. These documents can all be summarized, as standing for the position that:
>
> - generally, unless a derivative contract is a hedge for tax purposes of a capital transaction, the closing out of a derivative contract is on account of income; and
> - whether a specific derivative contract held by a taxpayer is a hedge for tax purposes of a capital transaction would depend on whether there was sufficient linkage between that specific derivative contract and an underlying capital transaction of the taxpayer such as the acquisition or disposition of a capital asset by the taxpayer or the repayment of a debt of the taxpayer which itself was on account of capital.[35]
>
> The CRA also noted in that document that while certain derivatives may form "part of [an entity's] ongoing treasury, financial and hedging operations and perhaps as an accounting and/or economic hedge for its investment in [a foreign subsidiary]" that connection does not constitute a linkage to an underlying capital transaction of the Canadian entity.
>
> Also, the CRA recently reiterated the linkage principle, stating as follows:
>
> In our opinion, there is insufficient linkage which would tie the foreign exchange gain, in [ACo] to any underlying capital transaction [in ACo]. An underlying transaction would be present where there is a purchase, a sale, or a repayment of debt. In this case, the Loan was not [ACo's] debt but that of [BCo]. Accordingly, the foreign exchange transaction [of ACo] was a speculation made in the hope of profit, which would be treated as an adventure in the nature of trade, and any gains should be taxed as business income. Conversely, foreign exchange losses would be deductible as business losses. Therefore, the foreign exchange gain of approximately $x made by [ACo] in the taxation year would be on account of income.[36]

Regardless of the type of derivatives that the above CRA statements specifically refer to (i.e., foreign exchange derivatives, commodity derivatives), the comments apply equally to other derivatives and

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provide guidance on the approach that CRA has administratively adopted in respect of transactions involving derivatives.[37]

Conclusion on Linkage

In all of the CRA administrative positions referred to above and the related jurisprudence, CRA and the courts have focused on the existence of linkage between the derivative and the underlying transaction to which the derivative relates in determining whether the gain or loss from the derivative is to be considered on income account or capital account. Where sufficient linkage exists between the derivative and the transaction to which it relates, the derivative takes on the income/capital treatment of the underlying transaction. The gain or loss on a derivative that is a hedge of produced substances, inventory or other items forming part of the business operations of a taxpayer will be treated as being part of the business income or loss and, accordingly, will be treated as being on income account. If the derivative involves the proposed disposition of a capital asset, the hedging of funds acquired and held for capital purposes or the investment of surplus idle funds which are held exclusively for capital purposes, then the gain or loss on the derivative will be characterized as being on capital account. Where an insufficient linkage exists to an underlying transaction, the derivative will be treated as being purely speculative and will be characterized as being on income account.

Part B: Ownership/Reporting of Derivative Gains and Losses

In a corporate group, it is not uncommon for a parent corporation to manage risks of the corporate group by entering into derivatives for its own account but related to the assets of other members of the corporate group. The related gains or losses on these derivatives are required to be reported by the parent corporation (the owner of the derivative), regardless of whose assets the derivative relates to. This taxation approach was the case, for example, in *Salada Foods* where the parent corporation entered into derivative contracts to protect against the devaluation of its investment in its foreign subsidiary. As stated by the Federal Court Trial Division in that case, and as has been repeatedly stated by CRA in their published administrative positions, a derivative contract entered into by a taxpayer to preserve the value of property (or income production from assets) of a foreign subsidiary will not be treated as being on capital account of the taxpayer, unless there is linkage to an actual or intended sale of capital property (i.e., the shares of the subsidiary).

CRA's published administrative positions have consistently recognized that the taxpayer that is required to report a gain or loss on a derivative transaction is the owner of the derivative. Where an agent has entered into a derivative on behalf of a principal, the CRA and the courts have consistently recognized this legal relationship and attributed any gain or loss to the principal (i.e., the beneficial owner). In the cases of *Echo Bay Mines* and *Placer Dome,* the courts recognized the existence of agency relationships between the parent corporation, as agent, and the subsidiary taxpayer, as principal. In those decisions, the Court recognized the derivatives gained or lost were the gains or losses of the principal.

In CRA Documents Nos. 2011-0418541I7 and 2012-0465561I7, CRA acknowledged the requirement that the gain or loss on the derivative be reported by the owner of that derivative, irrespective of whether the derivative contract was related to another party's assets or operations.[38]

There is no provision in the Act that requires or permits a Canadian taxpayer to enter into a derivative on its own account and for its own benefit to then transfer the gain or loss on the derivative to another party (i.e., a subsidiary). A gain or loss on a derivative transaction may only be reported by a

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subsidiary if the parent company entered into the derivative transaction as agent for the subsidiary or if the parent company has disposed of its interest in the derivative to the foreign subsidiary.[39]

However, as discussed in more detail in Part C below, recent assessing practices of CRA contradict these published administrative positions. The recent assessing practices suggest that CRA may seek to apply transfer pricing principles to transfer the tax effect of a derivative transaction to a member of a corporate group that never legally or beneficially owned the derivative.

Part C: A Novel Theory - The Latest CRA Approach

As outlined above, the tax treatment to be afforded to a derivative transaction has historically involved determining whether the related gain or loss on the derivative is on income account or capital account, applying the linkage principle, with the derivative gain or loss being reported by the owner of the derivative. In recent years, CRA has advanced a new approach to the taxation of derivatives in the multinational corporation setting.

In a situation where a Canadian parent corporation enters into a derivative transaction with an arm's length counterparty that is connected to the operations of a foreign subsidiary,[40] the latest CRA proposition is that the derivative gain or loss must be reported by the foreign subsidiary, irrespective of the fact that the foreign subsidiary has no legal obligation, or legal entitlement, to the risk or reward relating to the derivative transaction. For clarity, this CRA proposition is advanced even though CRA accepts that no principal-agent relationship exists between the foreign subsidiary and the parent corporation.

This CRA position conflicts with the extensive published CRA administrative positions outlined above. It also conflicts with the transfer pricing rules contained in the Act, the Transfer Pricing Guidelines published by the Organization for Economic Co-operation and Development ("OECD") and with contract law principles, as outlined further below.

Analysis of the Novel CRA Theory

Wording of Section 247

The transfer pricing rules in section 247 of the Act allow the Minister of National Revenue (the "Minister") to review and adjust certain transactions involving a Canadian taxpayer and a non-arm's length non-resident. Specifically, paragraph 247(2)(a) can be invoked by the Minister if a Canadian taxpayer and a non-arm's length non-resident can be said to be "participants in a transaction or series of transactions" and the terms and conditions of the transaction(s) between them are different than those terms and conditions that would have been entered into if the transactions were entered into between persons dealing at arm's length.[41]

The latest CRA approach is premised upon a theory that the transfer pricing rules in section 247 are sufficiently broad to be applied to an entity within a corporate group that never became a party to the derivative transaction. This CRA approach involves the assertion that transfer pricing rules should apply to transfer the tax effect of a derivative transaction entered into by a Canadian parent corporation with arm's length parties, to its foreign subsidiary where the derivative transaction has some connection to an asset or operations of that foreign subsidiary. In this regard, the CRA theory suggests that the foreign subsidiary has some perceived benefit from the existence of a derivative transaction and that the foreign subsidiary should realize the gain or loss associated with the

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derivative transaction pursuant to section 247(2). As discussed further below, this CRA position is built upon a foundation that the parent corporation and its subsidiary are “participants in” some expansive form of a transaction on the basis that the term “transaction” is defined to include an “arrangement or event”.[42]

CRA, in essence, asserts that there exists an automatic “arrangement” between a parent corporation and a foreign subsidiary, pursuant to which the parent corporation has entered into a derivative contract to manage risks inherent in that foreign subsidiary’s assets or undertaking, as a result of which the foreign subsidiary should be viewed as a party to the derivative arrangement. The ultimate effect of this novel CRA position is that the derivative gain or loss must be reported by the foreign subsidiary, regardless of there being no related privity of contract with the arm’s length counterparties and regardless of the fact that the foreign subsidiary has no obligation or entitlement (i.e., no risk or reward) under the derivative.

In considering this novel CRA approach, it is useful to consider the elements of subsection 247(2), which provides as follows:[43]

> 247(2) **Transfer pricing adjustment** – Where a taxpayer or a partnership and a non-resident person with whom the taxpayer or the partnership, or a member of the partnership, does not deal at arm’s length (or a partnership of which the non-resident person is a member) are participants in a transaction or a series of transactions and
>
> ***(a)*** ***the terms or conditions made or imposed, in respect of the transaction or series, between any of the participants in the transaction or series differ from those that would have been made between persons dealing at arm’s length, or***
>
> …
>
> any amounts that, but for this section and section 245, would be determined for the purposes of this Act in respect of the taxpayer or the partnership for a taxation year or fiscal period shall be adjusted (in this section referred to as an “adjustment) to the quantum or nature of the amounts that would have been determined, if
>
> ***(c)*** ***where only paragraph (a) applies, the terms and conditions made or imposed, in respect of the transaction or series, between the participants in the transaction or series had been those that would have been made between persons dealing at arm’s length, or***
>
> …

As outlined above, subsection 247(2) requires the existence of participants to a transaction. In this regard, the terms “participant”, “transaction” and “arrangement” must be considered in more depth.

“Participant”

Subsection 247(2) is only invoked if the Canadian taxpayer and a non-arm’s length non-resident were participants in a transaction. The term “participant” is not statutorily defined and reference must be made to other sources to define this term. *“*Participant*”* is defined in the *Shorter Oxford English Dictionary* as “a person who participates in something ... a person who takes part with another”.[44] “Participate” is defined as meaning to “take a part or share in an action or condition...”.[45]

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In addition, consideration of similar terms in the Act shed light on the term "participant". In one context, the Courts have stated that to be a participant, a party must have some element of knowledge and concurrence to what it is participating in.[46] In another context, the term "participant" was previously defined in subsection 248(1) of the Act (now repealed) to refer to a person that "has entered into a contract" (as it related to indexed security investment plans).

Applying the definition and statutory interpretation principles,[47] a party should at the very least, have some knowledge of and concurrence in a transaction to be considered a participant in that transaction. The type of concurrence needed under section 247(2) should be of such a level so as to result in the assumption of legal rights and obligations under the contract. Where there is no common knowledge and concurrence between parties, participation by those parties cannot be found to exist.

"Transaction"* and *"Transfer Price"

As indicated, the text of subsection 247(2) provides that transfer pricing adjustments will only be made where a taxpayer and a non-resident are "participants in a transaction or a series of transactions" and section 247 specifically requires that there must be a "transfer price" that is determinable in respect of any "transaction" between non-arm's length parties.[48] It is trite to say that if there is no transaction, there is nothing to transfer price and section 247 has no application.

"Arrangement"

Since a section 247 "transaction" includes an arrangement, the term "arrangement" must be analyzed. The term "arrangement" was considered by Lord Denning in the frequently cited Privy Council decision of *Newton v. The Commissioners of Taxation*,[49] where it was stated:

> Their Lordships are of the opinion that the word "arrangement" is apt to describe something less than a binding contract or agreement, something in nature of an understanding between two or more persons – a plan arranged between them which may not be enforceable by law.[50]

In *P.I.P.S. - Aircraft Operations Group v. Canada (Anti-Inflation Appeal Tribunal)*,[51] the Federal Court Trial Division also considered the term "arrangement" as that term was used in the guidelines under the *Anti-Inflation Act*[52] (the reference was to "an arrangement for the determination and administration of the compensation of employees"). The Federal Court Trial Division restricted the meaning of the term "arrangement" as follows:

> 5…the word "arrangement" must be given the sense of an agreement duly arrived at between agreeing parties and does not include a unilateral arrangement made by one party even though such arrangement benefits the other party.

The concept of an "arrangement" requires that there must be an explicit or implicit understanding and concurrence, whether formal or informal, between two or more parties. Unilateral knowledge and unilateral activity by one party should not give rise to an arrangement or a transaction that would invoke section 247. At the very least, an arrangement necessarily requires the interaction of two or more parties resulting in some form of mutual understanding involving the assumption of risk and benefits.

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This conclusion relating to the need for a mutual understanding between parties is further supported by reference to the word "between" contained in subsection 247(2). Under subsection 247(2), the terms and conditions of the transaction/arrangement *between* the non-arm's length parties must be contrasted to terms and conditions "that would have been made *between* persons dealing at arm's length". "Between" is defined in the *Shorter Oxford English Dictionary* as being "reciprocal action or relation involving two or more agents individually."[53] Reciprocal action, as opposed to unilateral action, is required and there must be a meeting of the minds before there are relations "between" those parties.

In *M.N.R. v. Granite Bay Timber Co.*,[54] the Exchequer Court contrasted unilateral action to reciprocal action "between" parties in the context of a resolution to dissolve a corporation. The Court held that the voting by shareholders to liquidate a corporation did not sufficiently give rise to a transaction between parties, given that the act of voting in and of itself did not create any legal rights or obligations. Instead, the Court noted that something more than the simple act of voting was required to find the existence of a transaction between the parties. It was only after the Court considered the passage of the resolution (which resulted from the voting and gave rise to legal rights) together with the consent of the shareholders to have property of the company vested in them that the Court concluded there existed a transaction "between persons not dealing at arm's length" as contemplated by the relevant legislation. The Court stated:

> That they consented in fact, is shown by their subsequent receipt and acceptance of property distributed pursuant to the resolution. This, in my opinion, is enough to turn the unilateral transaction of the company into a transaction *between parties*, within the meaning of the expression in section 8(3). In this view, the fact that, in voting for the resolution, the shareholders were simply exercising their legal rights as shareholders, rather than entering into a transaction, has no bearing on the question. They do not become parties to the transaction by virtue of their having voted for the resolution but by reason of their consent to take property rights under the transfer which it effected.[55]

In that case, binding legal rights and obligations between the shareholders and the company were created by the actions of the parties to accept a distribution of property. It is these binding rights and obligations and actions by both parties, with knowledge, that ultimately led the Court to determine that a transaction was concluded between the parties. Before that time, the unilateral action to dissolve the corporation was not a transaction between the corporation and its shareholders.

The CRA interpretation of section 247 under paragraph 36 of Information Circular 87-2R[56] supports this view and specifically refers to the need for mutual action by the parties before subsection 247(2) may be invoked:

> 36 Subsection 247(2) of the Act applies the arm's length principle through a review of the terms and conditions attached to transactions or series of transactions entered into between parties not dealing at arm's length.[57]

The above review of the relevant terms forming part of section 247 provides insight into the mechanics of that section. For a Canadian corporation and its foreign subsidiary to be considered "participants in a transaction", there must, at the very least, be some meeting of the minds, or something akin to actions or concurrence by both parties before a transaction arises.

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By imputing a gain or loss to a foreign subsidiary from a derivative contract unilaterally entered into by a parent corporation with an arm's length party, but related to an asset or operations of a foreign subsidiary, would be contrary to a proper reading of the language of section 247.

It is important to note that under paragraph 247(2)(a), there must exist terms and conditions to a transaction between non-arm's length parties before paragraphs 247(2)(a) and (c) can be invoked to alter such terms and conditions to arm's length terms. As such, evidence of foreign subsidiary's concurrence or involvement in a derivative transaction is needed before CRA should be entitled to invoke the transfer pricing rules to suggest that different terms and conditions should be applied to the derivative.

Without evidence of mutuality or concurrence, a transaction or arrangement should not be seen to have occurred between a parent corporation and its foreign subsidiary and section 247 should not be invoked.

OECD Transfer Pricing Guidelines[58]

This novel CRA approach is contrary to OECD Guidelines, which require actual transactions before transfer pricing guidelines can be applied. Article 9 of the OECD Model Tax Convention[59] deals with adjustments to profits resulting from transactions entered into between associated enterprises and outlines the authoritative arm's length principle as follows:

> [Where] conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

The Department of Finance Press Release dated September 11, 1997 released in conjunction with the then proposed subsection 247(2) and IC 87-2R accept these OECD Guidelines and stated:

> The proposed rules are in conformity with the revised (1995) transfer pricing guidelines of the [OECD], and are generally in keeping with the transfer pricing rules of other OECD member states, such as the U.S. Most notably, the draft amendments to the Act:
>
> > require taxpayers who participate in cross-border transactions with non-arm's length parties to conduct such transactions on terms and conditions that would have prevailed had the parties been dealing at arm's length with each other.

The most recent CRA position ignores its prior administrative positions and the OECD Guidelines. Instead, this novel CRA approach attempts to transfer gains and losses on the basis that another member of the corporate group has some perceived benefit from a parent corporation's transaction. Given the lack of any transaction between the parties, this approach is similar to the global formulary apportionment approach to transfer pricing referred to in the OECD Guidelines as follows:

> 1.16 Global formulary apportionment has sometimes been suggested as an alternative to the arm's length principle as a means of determining the proper level of profits across

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> national taxing jurisdictions. The approach has not been applied as between countries although it has been attempted by some local taxing jurisdictions.
>
> 1.17 Global formulary apportionment would allocate the global profits of an MNE group on a consolidated basis among associated enterprises in different countries on the basis of a predetermined and mechanistic formula…[60]

The global formulary apportionment approach has been soundly rejected by the OECD.[61] The OECD Guidelines specifically states:

> 1.32 … OECD member countries reiterate their support for the consensus on the use of the arm's length principle that has emerged over the years among member and non-member countries and agree that the theoretical alternative to the arm's length principle represented by global formulary apportionment should be rejected.[62]

General Contract Law Concepts

As discussed further below, once a contract has been formed between specific parties, a new party cannot be unilaterally added to that contract. If the foreign subsidiary is not party to the derivative contract with the arm's length counterparty, it cannot be added as a participant to such contract in the absence of an agreement among the parties to assign the contract or to novate the foreign subsidiary into the contract or in the absence of the foreign subsidiary being a party to that agreement in the first instance under a principal-agent relationship, or a trust relationship.

Recharacterization of Legal Relationships/Privity of Contract

Where a parent corporation enters into a derivative contract with an arm's length counterparty to mitigate corporate risk relating to the assets or operations of a foreign subsidiary, the derivative contract represents an agreement that is binding upon the parties thereto and represents a *bona fide* legal relationship that must be respected by the courts and CRA, absent a sham or provision of the Act to the contrary.[63]

As stated in *The Law of Contracts in Canada*[64]:

> As the word would suggest, "privity" involves the idea of being *privy* to a contract, that is, being a party to, or participant in a contractual arrangement. The common law drew, and still draws a distinction between (1) those who are involved in a contract, as being signatories (if the contract is in writing, whether with or without a seal), or, if it is oral, as being among those assenting to the contractual undertakings, and (2) those who claim rights under a contract, or upon whom it is sought to impose liabilities under a contract, when they were not involved in the original making of the contract and were not expressly engaged to or in it by their participation. An agreement between A and B involves only A and B as parties:[65] there is privity of contract between them. A contract between A and B which requires that A do something for C or that C do something for A creates no privity of contract between A and C or B and C.[66] The contract may mention C and may purport to confer a benefit upon C or impose an obligation upon C, but it cannot result in C's being a party to the contract in the ordinary, usual sense.[67] To acquire rights and be subject to liabilities under a contract, one must be a party to it.[68]

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No privity of contract exists in respect of a foreign subsidiary that is not a party to the derivative contract and that has no legal rights or obligations in connection with that derivative contract.

Exceptions to Privity of Contract

Paragraph 247(2)(c) does not alter the fundamental common law principle of privity of contract and does not allow the addition of a party to a contract or the vesting in an outsider of legal rights or obligations under a contract. It is well established law that for a person to be able to enforce a contract, consideration must have been given by that person to the promisor.[69] It follows then that a person who has not given consideration to the promisor cannot be bound by the terms and conditions of a contract pursuant to which it was not a party.[70] Even if a third-party beneficiary is entitled to benefit from that contract, that third party is only entitled to enforce the contract if one of the main exceptions to privity can be found: assignment, trust, collateral contract, tort law, statutory rights and agency.

In respect of assignment, if the corporation validly assigns its rights to its subsidiary under a contract, the subsidiary can acquire the contract, and the rights thereunder, as if it had entered into the contract itself. Any gain or loss on the contract could accordingly be realized by the subsidiary. However, the Master Agreements generally provide that "neither [the Master Agreement] nor any interest or obligation in or under [the Master Agreement] may be transferred … by either party without prior written consent of the other party …"[71] and "[a]ny purported that is not in compliance with this section will be void."[72] Thus, no assignment of rights by a parent corporation to its foreign subsidiary can generally occur under a Master Agreement absent the written consent of the counterparty. The novel CRA theory does not contend any valid assignment of a contract.

In the case of a trust, for this exception to apply, the rights and obligations to the Master Agreement would need to be considered held in trust by the parent corporation for the benefit of its foreign subsidiary. Any gain or loss on the contract could accordingly be realized by the subsidiary. However, similar to the issues encountered in respect of assignment, the parties to a Master Agreement are clearly stated therein. Thus a secondary trust agreement between the parent corporation and its foreign subsidiary would be contrary to the Master Agreement as the rights thereunder could only be transferred with the written consent of the other party (or otherwise void). The novel CRA theory does not contend the existence of any trust relationship.

The next three exceptions, collateral contract, tort law and statutory rights, would not generally apply in respect to derivative transactions. The collateral contract exception applies in circumstances where, for instance, the distribution of a manufacturer's goods occurs through dealers who purchase the goods from the manufacturer and then sell the goods to an ultimate consumer. Where the manufacturer has made a guarantee in respect of the goods, sometimes directly to the consumer, a collateral contract is formed between the manufacturer and the consumer in order to protect the consumer in respect of that guarantee. The tort law exception works in a similar manner, protecting the ultimate consumer in respect of a defective product caused by the negligence of the manufacturer. Finally, the statutory rights exception applies in circumstances where legislation provides rights to third parties that are not party to a contract. Examples of this exception are often seen in the insurance context where, for instance, the beneficiary of a life insurance policy can enforce the policy. The novel CRA theory does not assert the existence of any collateral contract, tort law or statutory exception.

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Finally, in dealing with the agency exception, there must exist a legal relationship between the parent company and the foreign subsidiary, such as where the parent corporation acted as agent for the foreign subsidiary in contracting in respect of a derivative transaction. An agency relationship arises where there is an express or implied contractual agreement between two parties and may also arise as a result of a ratification by the principal of the actions of the agent. There must exist a contractual bi-lateral relationship between the parties pursuant to which the agreement or conduct of the parties reflects that one party (i.e., the agent) consents to act "on behalf of" the other (i.e., the principal), with the principal being bound by the acts of the agent.[73] The creation of a binding agency relationship, like any other contractual relationship, generally requires two elements: the capacity of both parties to act and the mutual intent of both parties to enter into a binding legal relationship.[74] The finding of an agency relationship is also contrary to the clear terms of the Master Agreement which specifically defines the parties at risk and the parties entitled to the benefit of the derivative. Any deviation from the terms of the Master Agreement without the consent of the counterparty will be void and unenforceable against the counterparty. Of note, no agency relationship is asserted under the novel CRA theory.

Furthermore, in *Continental Bank of Canada v. R.*,[75] the Tax Court of Canada specifically commented on whether a parent corporation could be seen to be the agent of a subsidiary corporation. In reaching the conclusion that no agency relationship existed, the Court commented that it is very difficult to regard a parent corporation as agent for a subsidiary and extremely compelling evidence would be required to cause a parent corporation, at law, to be considered the subsidiary's agent. Accordingly, the existence of an agency relationship must be clear.

Respecting the Relationship

In addition, as a general rule, the legal relationships that taxpayers choose to enter into must be respected. This has been confirmed by the Courts.[76] The Federal Court of Appeal in *Dale v. The Queen*[77] agreed with the following comments of Justice Bowman in his decision at the Tax Court of Canada:[78]

> In the absence of a specific statutory provision,… **the Minister is not free to pick and choose which legal relationships he will recognize and which he will not**. The Minister is seldom, if ever, a party to legal relations between subjects although they affect him in that they create the foundation from which tax consequences emanate. **The Minister takes those relations as he finds them. The question is not whether he recognizes them. Rather, it is what is the true effect of the relations.** [Emphasis Added]

The Federal Court of Appeal confirmed the above cited principles in *Daishowa-Marubeni International Ltd. v. The Queen*[79] stating in the Majority decision that "[t]axpayers are taxed depending on what they did, not on what they might have done."[80]

The novel CRA position, which suggests the existence of an automatic legal relationship between a parent corporation and its foreign subsidiary in the context of transfer pricing, would have the effect of recharacterizing the actual legal relationship involving the parent corporation and the arm's length counterparty to the derivative contract. Not only is this clearly contrary to the terms of standard Master Agreements and the principle of privity of contract (where no exceptions can be found to exist), it is contrary to the CRA's administrative guidelines pertaining to transfer pricing which state that the business relationship must be accepted as documented, save for the exceptional and limited

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circumstances where recharacterization will be considered.[81] Circumstances in which recharacterization is permissible from a transfer pricing perspective include where the arrangements made in relation to the transaction differ from those that would have been made by independent parties acting in a commercially rational manner and the actual structure impedes the tax administration from determining an appropriate transfer price.[82] The starting point for this analysis is always the existence of a transaction between non-arm's length parties.

The most recent CRA theory, that imputes a legal relationship between the parent corporation and the subsidiary, where none exists at law, in respect of a derivative contract entered into by the parent corporation for its own benefit and risk, ignores general contract law and the base requirements of the transfer pricing rules. Where the foreign subsidiary is not party to a derivative transaction entered into by the parent company, the related gain or loss is also not owned by the foreign subsidiary. Section 247 does not provide authority for imputing a non-existent transaction and legal relationship and section 247 does not apply if no such transaction or relationship exists.

Conclusion

The taxation of derivatives is best characterized as involving taxation on the basis of linkage. If a derivative is linked to a capital transaction or a transaction in the ordinary course of the taxpayer's business, then the derivative takes on the same character for tax purposes as the underlying transaction to which it relates. If the derivative is not linked to a transaction, then the gain or loss on the derivative is considered to arise in the course of either the conduct of a business or a speculative transaction and is taxed on income account.

The law also makes it clear that the beneficial owner of the derivative is the party that must report the corresponding gain or loss from a derivative transaction. Only a party that has rights and obligations under a derivative (i.e., privity of contract) can be considered a beneficial owner unless one of the exceptions to privity of contract applies.

Any suggested change in these longstanding principles is unfounded and contrary to the law.

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[1] Anne, Jehad and Sophie are members of Dentons Canada's Calgary tax team.
[2] Margaret E. Grottenthaler et al, *The Law of Financial Derivatives in Canada*, loose leaf (last consulted in December 2013), (Toronto: Carswell, 2003), ch 1 at 3.
[3] *Atlantic Sugar Refineries Ltd. v. Minister of National Revenue,* [1949] C.T.C. 196 (SCC) [*Atlantic Sugar*].
[4] *Ibid* at para 12.
[5] *Ibid* at para 8.
[6] *Dominion Steel and Coal Corp. Ltd. v. Minister of National Revenue*, 16 Tax A.B.C. 427 (Tax Appeal Board) [*Dominion Steel*].
[7] *Minister of National Revenue v. Tip Top Tailors Ltd.*, [1957] C.T.C. 309 (SCC) [*Tip Top Tailors*].
[8] *Salada Foods Ltd. v. R.*, 74 D.T.C. 6171 (FCTD) [*Salada Foods*].
[9] *Ibid* at para 16.
[10] *Ibid* at paras 15-18.
[11] The Court's finding that the transaction was an adventure in the nature of trade and thus taxable on income account is also consistent with *M.N.R. v. Taylor,* [1956] C.T.C. 189 and *Friesen v. The Queen,* [1995] 3 S.C.R. 103, where the meaning of the term "adventure or concern in the nature of trade" was considered. In those cases, it was determined that "[t]he concept of an adventure or concern in the nature of trade is a judicial creation designed to determine which purchase and sale transactions are of a business nature and which are of a capital nature" (*Friesen* at para. 25) and that such determination depends on the character and surrounding circumstances of the transaction.
[12] *Salada Foods, supra* note 8 at paras 21, 23.
[13] *Ethicon Sutures Ltd. v. R.*, [1983] C.T.C. 2758 (T.C.C.) [*Ethicon Sutures (TCC)*]; aff'd 85 D.T.C. 5290 (FCTD) [*Ethicon Sutures*].
[14] *Ethicon Sutures (TCC), supra* note 13 at para 25.

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[15] *Ethicon Sutures, supra* note 13 at paras 24-27, 34.
[16] *Shell Canada Limited v. R.*, 99 D.T.C. 5669 (SCC) [*Shell Canada*].
[17] *Echo Bay Mines Ltd. v. Canada,* 92 DTC 6437 (FCTD) [*Echo Bay Mines*].
[18] *Ibid* at para 20.
[19] *Ibid* at paras 21-22.
[20] *Placer Dome Canada Ltd. v. Ontario (Minister of Finance)*, 2006 SCC 20 [*Placer Dome*]
[21] *Mining Tax Act* (Ontario), R.S.O. 1990.
[22] *Placer Dome, supra* note 20 at para 29.
[23] *Ibid* at para 34.
[24] *Ibid* at para 2.
[25] *Ibid* at para 12.
[26] *Ibid* at para 8.
[27] *Shell Canada*, *supra* note 16.
[28] *Ibid* at para 68.
[29] See (a) Interpretation Bulletin IT-346R, *Commodity Futures and Certain Commodities*, published November 20, 1978; (b) Interpretation Bulletin IT-95R, *Foreign Exchange Gains and Losses*, published December 16, 1980; (c) 1984 Revenue Canada Roundtable Question 63; (d) AC57744, *Adjustments to Cost Base – Partnership Interest Deduction*, April 19, 1990; (e) CRA Document No. 2009-0337801R3 – *Foreign affiliates – hedging indebtedness*, published 2009; (f) CRA Document No. 2009-0345921I7, *Derivatives – income or capital*, published April 15, 2010; (g) CRA Document No. 2009-0348961I7, *Foreign exchange/gains and losses*, published April 15, 2010; (h) CRA Document No. 2009-0352061I7, *Foreign exchange gains/losses on hedges*, published March 12, 2010; (i) CRA Document No. 2010-0355871I7, *Derivatives - income or capital*, published April 21, 2010; (j) CRA Document No. 2010-0367611I7, *Cross currency swap - income or capital*, published October 12, 2010; (k) CRA Document No. 2011-0418541I7, *xxxxxxxxxx hedges*, published July 10, 2012; (l) 2012-0465561I7, *Hedging transaction*, published December 21, 2012.
[30] Interpretation Bulletin IT-346R, *supra* note 29, at paras 3, 4, 5 and 10.
[31] See (a) CRA Document No. 2009-0352061I7, *supra* note 29; (b) CRA Document No. 2009-0348961I7, *supra* note 29; (c) CRA Document No. 2009-0345921I7, *supra* note 29; (d) CRA Document No. 2010-0355871I7, *supra* note 29.
[32] CRA Document No. 2009-0352061I7, *supra* note 29.
[33] CRA Document No. 2009-0345921I7, *supra* note 29.
[34] CRA Document No. 2010-0367611I7, *supra* note 29.
[35] CRA Document No. 2011-0418541I7, *supra* note 29.
[36] CRA Document No. 2012-0465561I7, *supra* note 29.
[37] As evidenced by CRA comments in CRA Document No. 2011-0418541I7, *supra* note 29.
[38] See also CRA Document Nos. 2009-0345921I7, 2009-0348961I7, 2009-0352061I7, 2010-0355871I7, *supra* note 29, which recognize that the owner of the derivative contract should report the gain or loss thereon.
[39] See CRA Document No. 2011-0418541I7, *supra* note 29.
[40] While this paper focuses on the CRA theory as it relates to transferring the tax effect of a derivative from a Canadian parent corporation and a foreign subsidiary, the discussion in the paper should apply equally to other intergroup transfers of the tax effect of a derivative.
[41] Subsection 247(2) of the Act.
[42] Subsection 247(1) of the Act.
[43] The CRA novel theory is premised upon the application of subparagraphs 247(2)(a) and (c) of the Act.
[44] *Shorter Oxford English Dictionary*, 6th ed, *sub verbo* "participant".
[45] *Ibid, sub verbo* "participate".
[46] In the context of the penalty provisions of subsection 163(2) and former subsection 56(2), and in determining whether persons "participated in... a false statement or omission", the Exchequer Court determined that "participated in ... connotes an element of knowledge and … [the] concurrence of the principal's will to the act or omission of his agent, or a tacit and silent concurrence" when considering whether a principal participated in the actions of its agent. (See *Udell v. M.N.R.*, 70 D.T.C. 6019 (Ex.Ct.) The Tax Court of Canada later commented that persons could not have "participated in... the false statement or omission" if "the evidence was unable to establish that the taxpayers were aware or that they might even have suspected that their respective agents had committed errors". (See *Nieto v. M.N.R.*, 85 D.T.C. 365 (T.C.C.) at paragraph 30.).
[47] Principles of statutory interpretation generally require that the same words be given the same meaning throughout a statute, unless there is something to indicate otherwise. *Sullivan on the Construction of Statutes*, 5th ed. (Markham: LexisNexis, 2008) at pages 214 to 215.
[48] See subclause 247(3)(a)(ii)(B) and subparagraph 247(4)(a)(v) of the Act.
[49] *Newton v. The Commissioners of Taxation*, [1958] 2 All E.R. 759.

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[50] *Ibid* at page 763.
[51] *P.I.P.S. - Aircraft Operations Group v. Canada (Anti-Inflation Appeal Tribunal)*, [1978] 2 F.C. 284.
[52] S.C. 1974-75-76, c. 75.
[53] *Supra* note 44, *sub verbo* "between".
[54] *M.N.R. v. Granite Bay Timber Co.*, 58 D.T.C. 1066 (Ex. Ct.) [*Granite Bay Timber Co.*].
[55] *Ibid* at para 16.
[56] Released on September 27, 1999.
[57] Canada Revenue Agency, Information Circular, 87-2R, *International Transfer Pricing*, September 27, 1999, at para 36 ("IC 87-2R").
[58] OECD Transfer Pricing Guidelines for Multinational Enterprises & Tax Administrations (2010) ("OECD Guidelines (2010)") and OECD Transfer Pricing Guidelines for Multinational Enterprises & Tax Administrators (1995) ("OECD Guidelines (1995)") (referred to together as the "OECD Guidelines").
[59] OECD (2012), Model Tax Convention on Income and on Capital 2010 (updated 2010), OECD Publishing.
[60] OECD Guidelines 2010, *supra* note 58 at paras 1.16 - 1.17.
[61] *Ibid* at paras 1.21 - 1.32.
[62] *Ibid* at para 1.32.
[63] *Shell Canada*, *supra* note 16 at para 39.
[64] G.H.L. Fridman, *The Law of Contracts in Canada*, 5th ed (Toronto: Carswell, 2006) [*Fridman on Contracts*] at page 175.
[65] (Footnote from quote) And that contract cannot be used to construe or explain a contract between *other* parties: *Forgan v. Lovatt* (2001), 160 Man. R. (2d) 123 at 127 (Man. C.A.) *per* Scott C.J.M.
[66] (Footnote from quote) *Datile Financial Corp. v. Royal Trust Corp. of Can.* (1991), 5 O.R. (3d) 358 (Ont. Gen. Div.); reversed in part on other grounds (1992), 11 O.R. (3d) 224 (Ont. C.A.); *MacDonald v. Matheson* (1986), 57 Nfld. & P.E.I.R. 268 (P.E.I.C.A.), contract for supply of dentures between patient and dentist: payment to be made by the Department of Vetran Affairs: only the patient and the dentist were parties to the contract; *R. v. Rottiers* (1995), 126 Sask. R. 81 (Sask. Q.B.); affirmed (1995), 134 Sask. R. 152 (Sask. C.A.), agreement between federal government and province as to trials in French conferred no rights on defendant who was not party to the agreement. Compare *Watson v. C.F. Hart Ltd.* (1986), 59 Nfld. & P.E.I.R. 308 (Nfld. Dist. Ct.); *Iampen v. Royal Bank* (1987), 79 A.R. 305 (Alta. Master). Contrast *Moss v. Richardson Greenshields of Can. Ltd.*, [1988] 4 W.W.R. 15 (Man. Q.B.); affirmed [1989] 3 W.W.R. 50 (Man. C.A.), where the broker was held to be privy to an options trading agreement entered into by the plaintiff, an investor; *Dale v. Manitoba* (1995), 128 D.L.R. (4th) 512 (Man. Q.B.), contract between provincial government and University of Manitoba could result in contract between student and university (affirmed (1997), 147 D.L.R. (4th) 605 (Man. C.A.)): compare above, p. 29.
[67] (Footnote from quote) E.g., *Maritime Life Assurance Co. v. Regional Capital Properties Corp.* (1996), 44 Alta. L.R. (3d) 267 (Alta. Master); affirmed (1996), 195 A.R. 102 (Alta Q.B.); affirmed (1997), 57 Alta. L.R. (3d) 401 (Alta. C.A.), borrower of money not a party to contract between CMHC and bank, therefore plaintiff, the borrower, could not sue CMHC. A more liberalizing attitude to privy was adopted in Australia in *Trident General Insurance Co. v. McNiece Brothers Proprietary Ltd.* (1988), 165 C.L.R. 107 (Australia H.C.).
[68] (Footnote from quote) *Rummery v. Matthews,* [2000] 9 W.W.R. 286 (Man. Q.B.), varied [2001] 11 W.W.R. 473 (Man. C.A.); additional reasons at [2001] 11 W.W.R. 486 (Man. C.A.).
[69] *Dunlop Pneumatic Tyre Co. Ltd. v. Selfridge & Co. Ltd.*, [1915] A.C. 847 at 853.
[70] Directly, by assignment, or otherwise.
[71] Master Agreement at para 7.
[72] Master Agreement at para 7.
[73] As discussed above in *Echo Bay Mines,* it was an accepted fact that the U.S. parent corporation acted on behalf of the taxpayer, which was its Canadian subsidiary. Thus, at law the economic results of the financial derivative transactions were for the account of the Canadian subsidiary.
[74] G.H.L. Fridman, *The Law of Contracts in Canada*, 5th ed. (Toronto: Carswell, 2006) [*Fridman on Contracts*] at pages 138 and 81 to 82.
[75] *Continental Bank of Canada v. R.*, 94 D.T.C. 1858 (T.C.C.) [*Continental Bank of Canada*].
[76] See *Shell Canada, supra* note 16.
[77] *Dale v. The Queen*, 97 D.T.C. 5252.
[78] *Dale v. The Queen*, 94 D.T.C. 1100 at para 48.
[79] *Daishowa-Marubeni International Ltd. v. The Queen*, 2011 FCA 267.
[80] *Ibid* at para 96.
[81] IC 87-2R, *supra* note 57 at paras. 43-44, referencing paragraph 1.37 of the OECD Guidelines (1995) referencing the very narrow circumstances that must exist before a recharacterization will be considered.
[82] Subsection 47(2) of the Act.

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