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Derivative Instruments — New Clarity for Characterization

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Taxpayers should now have more certainty and guidance when analyzing the income tax treatment of derivative instruments that involve an underlying capital asset. The Supreme Court of Canada's (SCC) recent decision in *MacDonald v. The Queen* (2020 SCC 6), which was released on March 13, 2020, may help with determining the tax treatment of gains and losses from derivatives as on income account or on capital account. The decision built on past jurisprudence to confirm the relevant framework and specific principles to characterize such gains and losses.

Background
A derivative is a contract or agreement between two or more parties that derives its value from fluctuations in the price of an underlying asset (e.g., corporate share or bond) or reference rate (e.g., interest rate or stock index). To determine whether gains or losses arising from derivative contracts are taxable on income or capital account, the key question to be analyzed is whether the derivative instrument is used to hedge against the risk of a particular exposure (e.g., foreign exchange risk, market risk, interest rate risk, credit risk) or to earn income from speculation on future movements in the value of the underlying asset, liability or reference rate. Generally, gains and losses from hedging derivative contracts will take on the character of the underlying asset being hedged. For example, if a derivative hedges financial risk that is linked to capital property, gains and losses from the derivative should be characterized as capital gains or losses.

SCC Decision

In the case at hand, a majority of SCC (i.e., eight out of nine judges) ruled that an individual taxpayer (Mr. M) was hedging his public company shares under a cash-settled forward contract. The majority of the SCC upheld the Federal Court of Appeal's (FCA)'s previous decision and concluded that since Mr. M held the underlying shares as capital property, Mr. M's cash settlement payments of approximately $10 million made under the contract resulted in capital losses, rather than business losses.

The majority found that the forward contract's purpose was clearly to hedge the market price fluctuation risk to which Mr. M's shares were exposed in light of the particular factual context of the case. The majority held that past jurisprudence supports the conclusion that the characterization of a derivative contract depends on the contract's purpose—the taxpayer's stated (subjective) intention is not determinative and, past cases demonstrate that, the main source for determining a derivative's purpose is the extent of the "linkage" between the derivative and any underlying asset, liability or transaction purportedly hedged. The majority confirmed that the analysis for "linkage" begins with identifying the underlying asset, liability or transaction of the derivative that exposes the taxpayer to financial risk and then considering the extent to which the derivative mitigates or neutralizes the identified risk. The majority also commented on factors relevant and irrelevant in the "linkage" analysis.

KPMG observations

This decision may be helpful in outlining the framework and principles that may be relied on to characterize derivative instruments for tax purposes. These principles include that:

- Timing between settlement of the derivative and the realization of gains or losses from the underlying asset or transaction does not need to match in order to find a hedging purpose
- Settlement of derivatives by physical delivery of the underlying asset or by cash is not determinative in the "linkage" analysis
- The "linkage" analysis to determine whether a derivative is a hedge involves two steps, first, pinpoint the financial risk to which the underlying asset, liability or transaction is exposed, and, second, evaluate how effective the derivative is at mitigating or neutralizing that risk
- Consider related transactions or assets that may be outside of the derivative contract in the "linkage" analysis.

We can help

Your KPMG advisor can help you assess how this decision may affect the tax implications regarding derivative instruments. We can also keep you updated on any tax-related legislative changes in this particular area that may arise in the months ahead.
