Monetization, Realization, and Statutory Interpretation

Paul D. Hayward*

PRÉCIS

Dans de nombreux cas, un investisseur qui détient une participation significative dans une société ouverte ne veut pas ou ne souhaite peut-être pas la vendre à cause de certaines « contraintes » fiscales et autres qui pourraient s'appliquer à une telle opération. À cause de la croissance phénoménale et de la complexité des produits dérivés au cours de la dernière décennie, un tel investisseur dispose dorénavant d'une solution de rechange fort intéressante à la vente conventionnelle, à savoir la « vente synthétique » ou « monétisation des participations ».

En ayant recours à de telles stratégies, un investisseur peut, dans de nombreux cas, « liquider » ses participations tout en reportant ou en évitant les conséquences fiscales négatives et peut-être même certaines autres conséquences associées à une vente formelle de ces biens. Toutefois, dans la mesure où de telles stratégies permettent à un investisseur d'éviter les coûts ou les restrictions autrement associés à une vente, elles peuvent poser un défi considérable aux parties qui cherchent à imposer, réglementer, surveiller ou limiter autrement de telles opérations.

Appliquées dans un contexte fiscal, les stratégies de monétisation donnent de bons résultats et ce, pour deux raisons. Premièrement, la Loi de l'impôt sur le revenu applique fréquemment des traitements différents à des positions financières équivalentes ou presque. Lorsqu'une position donnée entraîne un résultat fiscal défavorable, il est souvent possible d'établir une position financière qui donne un résultat plus favorable en exploitant l'absence d'uniformité dans le traitement que la Loi réserve à des positions économiques équivalentes. Les stratégies de monétisation mettent habituellement l'accent sur la distinction entre la constatation des gains sur la base de la matérialisation et sur la base de la régularisation. De telles stratégies tentent de générer autrement (par exemple, un prêt garanti par une option de vente) les liquidités auxquelles la matérialisation d'un événement (une vente, par exemple) donnerait lieu.

Selon l'auteur, la monétisation devrait être vue comme une forme de matérialisation. Les termes « monétisation des participations » et « matérialisation des participations » seraient à peu près synonymes du fait qu'ils renvoient essentiellement à la conversion

* Legal counsel, Corporate Finance, Ontario Securities Commission. I wish to thank Amin Mawani, Tim Edgar, and Deborah Toaze for helpful comments in the preparation of this article. Any errors or omissions are my sole responsibility. The views expressed in this article reflect my personal views and do not necessarily reflect the views of the Ontario Securities Commission or the staff of the commission.

de participations en argent. En théorie, la notion de matérialisation devrait pouvoir s'appliquer tout autant à l'investisseur qui « encaisse » par suite d'une monétisation qu'à celui qui « encaisse » par suite d'une vente. En pratique, cependant, les tribunaux seront prêts à étendre la notion de matérialisation à diverses stratégies de monétisation. Aux États-Unis et au Canada, l'usage répandu des stratégies de monétisation pour réaliser des reports d'impôt significatifs implique que les praticiens et les investisseurs les voient comme une façon efficace de réaliser un gain sans qu'il soit formellement reconnu comme la matérialisation d'un événement.

Deuxièmement, les stratégies de monétisation donnent aussi de bons résultats à cause de la méthode d'interprétation de la législation fiscale par la Cour suprême du Canada. La jurisprudence récente a créé un climat hautement favorable à la croissance de stratégies basées sur les produits dérivés, qui repose sur les traitements distincts réservés par la Loi à des positions financières équivalentes. La volonté apparente de la cour de tolérer des stratégies d'évitement fiscal audacieuses fondées sur des instruments financiers élaborés soulève des préoccupations en matière de politique fiscale en ce qui a trait à l'efficience, la neutralité, l'équité et la simplicité. Elle soulève également des préoccupations politiques dans d'autres domaines du droit, comme le droit des sociétés et des valeurs mobilières.

ABSTRACT

In many cases, an investor who holds a substantial equity position in a public company may be unable or unwilling to sell the securities owing to the existence of certain tax and non-tax "constraints" that may apply to a sale of the securities. As a result of the phenomenal growth in the use and sophistication of derivatives over the last decade, however, such investors now have a highly attractive alternative to a conventional sale: a "synthetic sale" or an "equity monetization."

Through the use of such strategies, an investor can in many cases effectively "cash out" an equity position while deferring or avoiding the adverse tax consequences, and perhaps certain non-tax consequences, that may be associated with a formal sale of such a position. However, to the extent that such strategies allow an investor to avoid the costs or restrictions that would otherwise apply to a sale, they can present a significant challenge to parties who seek to tax, regulate, monitor, or otherwise constrain such transactions.

Monetization strategies are successful in a tax context primarily for two reasons. First, the Income Tax Act (Canada) frequently applies different treatments to equivalent or near equivalent financial positions. When a given position yields an undesirable tax result, it is often possible to construct an equivalent financial position that yields a more desirable result by means of exploiting the Act's failure to treat equivalent economic positions consistently. Monetization strategies typically focus on the distinction between realization-based recognition of gains and accrual-based recognition of gains. Such strategies attempt to produce the cash that would be generated by a realization event (such as a sale) by a means other than a realization event (such as a secured loan combined with a put option).

The author argues that monetization should be viewed as a form of realization. The terms "equity monetization" and "equity realization" could almost be synonyms, in that they both essentially refer to the conversion of equity into cash. The concept of realization should in theory have as little difficulty in reaching an investor who "cashes out" by way of a monetization as it does an investor who "cashes out" by way of a sale. In practice, however, it is unlikely that the courts will be prepared to extend the concept of realization to various monetization strategies. The widespread use of monetization strategies in the United States and Canada to achieve significant tax deferrals suggests that practitioners and investors view them as an effective way to realize a gain without the act being formally recognized as a realization event.

The second reason monetization strategies are successful in a tax context relates to the Supreme Court of Canada's approach to statutory interpretation of tax legislation. The court's recent jurisprudence has created highly fertile conditions for the growth of derivative-based strategies, which make use of the distinctions in the Act's treatment of equivalent financial positions. The court's apparent willingness to tolerate aggressive tax-avoidance schemes based on the use of sophisticated financial instruments raises significant tax policy concerns in the areas of efficiency, neutrality, tax fairness, and simplicity. It also raises significant policy concerns in other areas of law, such as corporate and securities law.

KEYWORDS: ARBITRAGE ■ DERIVATIVES ■ DISPOSITION ■ GAAR ■ REALIZATION ■ STATUTORY INTERPRETATION

CONTENTS

INTRODUCTION

An investor who holds a substantial equity position in a public company may wish to sell some or all of the securities that make up this position in order to diversify his or her holdings and to reduce risk. In many cases, however, the investor will be unable or unwilling to sell the securities because of certain tax and non-tax "constraints" that may apply to a sale of the securities. As a result of the phenomenal growth in the use and sophistication of derivatives over the last decade, however, such investors now have a highly attractive alternative to a conventional sale: a "synthetic sale" or an "equity monetization."

In many cases, such a strategy can enable an investor to "cash out" a substantial equity position and defer or avoid the adverse tax consequences (and perhaps certain non-tax consequences) associated with a sale; the investor can receive a cash amount substantially equivalent to proceeds of disposition and transfer substantially all of the economic risk and return associated with the securities without formally transferring the legal and beneficial ownership of the securities.

To the extent that costs or other restrictions are associated with a conventional sale of securities, a monetization strategy represents a highly attractive alternative to a conventional sale. But to the extent that monetization allows an investor to avoid those costs or restrictions, it presents a significant challenge to those who seek to tax, regulate, monitor, or otherwise constrain such transactions.

A number of factors may make a conventional sale of securities unattractive to an investor with a substantial equity position; for example,

- a sale may trigger a significant tax liability on an accrued capital gain on the securities;[1]
- the investor may be subject to securities law restrictions or public notice filing requirements in connection with a sale, including insider reporting requirements, a prohibition on trading while in possession of material undisclosed information about the issuer, control block restrictions, "hold period" restrictions; and escrow requirements;[2]
- the investor may be subject to restrictions under a corporate statute such as the Canada Business Corporations Act,[3] including potential civil liability to a counterparty and to the corporation if a corporate insider purchases or sells a security of the corporation with knowledge of confidential information; and
- the investor may be subject to contractual restrictions that prohibit the sale of the securities, including restrictions in stock-based compensation arrangements, lockup agreements, escrow agreements, and issuer compliance policies.

These examples are far from exhaustive, and are simply intended to illustrate the constraints associated with a conventional sale of securities, ranging from simple public disclosure[4] of the sale to tax consequences triggered by the sale to an outright prohibition of the sale. It is not difficult to envision other circumstances that may create similar constraints—for example, where an investor is involved in an acrimonious family law proceeding and wishes to conceal from a spouse the fact that the investor has secretly cashed out a substantial equity position.[5]

In Canada, it seems reasonably clear that the first consequence noted above—the adverse tax consequences triggered by a sale—can be avoided (for a time, at least) through a properly conceived and executed monetization strategy. The extent to which a monetization strategy can be used to avoid the non-tax consequences noted above is far less clear. Much of the controversy surrounding monetization strategies appears to arise not because of their potential use as a tax-avoidance strategy—

1 The adverse tax consequences that may result from a sale and that are a principal motivation behind most monetization strategies are considered later in this article.

2 The securities law restrictions and other non-tax restrictions associated with a sale are considered briefly in the section entitled "Non-Tax Policy Considerations."

3 RSC 1985, c. C-44, as amended.

4 A requirement to make public disclosure of a sale may in many cases be of little concern to an investor. In that case, the constraining effect of this requirement will be minimal. In other cases, however, an investor may be anxious to conceal his trading activities (and the fact that he wishes to "cash out") from a spouse, other family members, a business partner, or investors generally. In such cases, a requirement to give public notice of the sale may be a significant constraint.

5 An example is considered in the section entitled "Non-Tax Policy Considerations."

which is widely accepted as legitimate[6]—but because of their potential application to non-tax-avoidance strategies. For example, Eric Reguly commented as follows:

> The enterprising souls on Bay Street have a little service, which they call equity monetization, which allows company insiders to convert the value of their shares into cash confidentially. Your shareholders won't know, Revenue Canada won't know, your spouse won't know and the Ontario Securities Commission won't know. . . .
>
> Equity monetization is not illegal and probably has some legitimate uses, such as estate planning, though few others leap to mind. A mockery of market transparency is what it really is, and the hypocrisy is astounding. Bay Street is supposed to be the steward of investor confidence. Yet Bay Street simultaneously offers a service that can be used to thwart investor confidence. Investors have a right to know about the economic position of a company's senior officials, which is why salaries, stock option plans and other employment incentives are made public. Equity monetization can be used to disguise a material change in an officer's true economic position.[7]

Similarly, Mercer Human Resource Consulting Limited, a compensation consulting firm, commented on the potential application of monetization strategies to defeat stock-based compensation arrangements:

> As compensation consultants, we frequently design equity-based compensation programs that are designed to tie executives to the company's stock and, thus, to the shareholder experience. This equity exposure is typically a fundamental objective of the plans we design. While we understand the portfolio diversification, risk and financial security needs of the individual executives that cause executives to hedge their positions, such hedging defeats one of the central objectives of these plans. Similarly, we encourage our clients to adopt share ownership guidelines and disclose executives' progress in achieving the required ownership levels; again, undisclosed hedging leaves shareholders unaware of the true extent of the executive's exposure to the stock.[8]

---

6 Proponents of monetization strategies invariably tout their "legitimate" uses in estate planning (that is, tax avoidance) and effective tax planning (that is, tax avoidance). They usually claim that they do not advocate or condone their "illegitimate" uses—for example, as a covert means by which an insider can cash out a substantial equity position.

7 Eric Reguly, "Investor-Friendly Web Page To Thwart Equity Monetization," *Globe and Mail*, December 7, 2000. See also, among many other articles in a similar vein, Eric Reguly, "Royal Bank's 'Synthetic Sales' Are Attack on Disclosure," *Globe and Mail*, February 15, 2000. See also Nina Mehta, "Cashing Out," *Derivatives Strategy*, September 2000 (available online at http://www.derivativestrategy.com); Stuart Weinberg, "Insiders Hedge with Zero-Cost Collars," *Wall Street Journal*, August 7, 2002; Doug Steiner, "Technically Legal" (2002) vol. 19, no. 4 *Report on Business Magazine* 29; Karen Howlett, "Cash Deals Should Be Disclosed: Observers," *Globe and Mail*, October 24, 2002; R. Deruyter, "Secret Stock Deals Irk Regulators—Executives Skirt Insider-Trading Rules with Financial Planning Tool," *Kitchener-Waterloo Record*, December 7, 2002; and "Monetization Rule Backed—Said To Involve Billions," *National Post*, March 6, 2003.

8 See the Mercer comment letter dated May 30, 2003, submitted in response to the request for comments on proposed *Multilateral Instrument* 55-103, "Insider Reporting for Certain Derivative Transactions (Equity Monetization)," February 28, 2003 (available online at http://www.osc.gov.on.ca). See also the comments of Bill Mackenzie, president of Fairvest Corp.:

My intention is not to consider specifically the application of monetization strategies to areas of law other than tax law. I will, however, argue that the reasons for a monetization strategy's success in a tax context may have important ramifications in the other areas of law noted above.

Monetization strategies succeed in a tax context primarily for two reasons. First, the Income Tax Act[9] frequently applies different treatments to equivalent or nearly equivalent financial positions. If a given position yields an undesirable tax result, it is often possible to construct an equivalent financial position that yields a more desirable result. Monetization strategies typically focus on the distinction between realization-based recognition of gains and accrual-based recognition of gains. Such strategies attempt to produce the cash that would be generated by a realization event (such as a sale) by a means other than a realization event (such as a secured loan combined with a put option).

I will argue that monetization should be viewed as a form of realization. In fact, "equity monetization" and "equity realization" could almost be synonyms, in that they both refer to the conversion of equity into cash. The concept of realization should, in theory, have as little difficulty in reaching an investor who cashes out by means of a monetization as it does an investor who cashes out by means of a sale. However, in practice the widespread use of monetization strategies to achieve significant tax deferrals suggests that practitioners and investors view monetization strategies as an effective way to realize a gain without the act being formally recognized as a realization event.

The second reason monetization strategies are successful in a tax context has to do with the Supreme Court of Canada's approach to statutory interpretation of tax legislation and the court's apparently benign[10] attitude to tax-avoidance transactions. As Brian Arnold has noted, over the last decade "the Supreme Court has refused to strike down several blatant tax-avoidance schemes,"[11] either under ordinary principles of statutory interpretation or through consideration of the general anti-avoidance

"Provincial regulators should ultimately look at whether equity monetizations should be legal at all . . . because they often defeat the purpose of providing stock-based compensation to managers." (Quoted in Steve Maich and Derek DeCloet, "OSC Takes Aim at Trading Loophole," *National Post*, February 27, 2003.)

9 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the "Act").

10 The suggestion that the Supreme Court of Canada has exhibited a "benign attitude" to tax avoidance is made (persuasively, in my view) by Brian J. Arnold, "Reflections on the Relationship Between Statutory Interpretation and Tax Avoidance" (2001) vol. 49, no. 1 *Canadian Tax Journal* 1-39. See also Brian J. Arnold, "Statutory Interpretation: Some Thoughts on Plain Meaning," in *Report of Proceedings of the Fiftieth Tax Conference*, 1998 Conference Report (Toronto: Canadian Tax Foundation, 1999), 6:1-36, at 6:26 et seq., and Neil Brooks, "The Responsibility of Judges in Interpreting Tax Legislation," in Graeme S. Cooper, ed., *Tax Avoidance and the Rule of Law* (Amsterdam: IBFD Publications, 1997), 93-129. But compare Joel Nitikman and Derek Alty, "Some Thoughts on Statutory Interpretation in Canadian Tax Law—A Reply to Brian Arnold" (2000) vol. 20, no. 20 *Tax Notes International* 2185-2223.

11 Arnold, "Reflections," supra note 10, at 2.

rule (GAAR) in section 245 of the Act. The court's recent jurisprudence has created highly fertile conditions for the growth of derivative-based strategies that exploit these distinctions in the treatment of equivalent financial positions.

Although the Supreme Court of Canada has not, to my knowledge, had an opportunity to consider a monetization transaction specifically, it has considered another highly sophisticated financing arrangement involving derivatives. If there was previously any concern as to whether the court would strike down a monetization arrangement on the grounds that it represented an unacceptable tax-avoidance strategy, the court's 1999 decision in *Shell Canada Ltd. v. The Queen*[12] must have allayed that concern. Indeed, in a recent technical interpretation, the Canada Customs and Revenue Agency (CCRA) explicitly cites the *Shell Canada* decision as the basis for its decision that "a short sale transaction to hedge an individual's position with respect to identical shares . . . will not be considered a disposition, for purposes of the Act, of other shares held by the borrower that are otherwise identical to the borrowed shares and which are ultimately used to settle the short position."[13]

I will argue that the Supreme Court's apparent willingness to tolerate aggressive tax-avoidance schemes based on the use of sophisticated financial instruments is unfortunate for the following reasons:

- it creates significant tax policy concerns in the areas of efficiency, neutrality, tax fairness, and simplicity; and
- it creates significant corporate and securities law policy concerns. First, it raises a serious question whether the court will adopt a similarly passive approach to avoidance transactions in these other areas of law. Second, the refusal to police aggressive tax-avoidance schemes involving derivatives may encourage the development and proliferation of strategies for the avoidance of restrictions under those other regimes.

This article addresses the following aspects of monetization strategies:

- the history of equity monetization transactions, including a description of the Estée Lauder "short sale against the box" transaction, which led to the enactment of the "constructive sale" rules in 1997 in the United States;
- a brief description of some basic equity monetization strategies;
- the principal motivations behind the use of such strategies;
- why monetizations are successful from a tax-planning perspective;
- the tax treatment of such strategies in the United States, particularly the constructive sale rules in section 1259 of the US Internal Revenue Code;[14]

12 [1999] 4 CTC 313 (SCC).

13 CCRA document no. 2002-0131355, July 3, 2002.

14 Internal Revenue Code of 1986, as amended (herein referred to as "the Code").

- the tax treatment of such strategies in Canada and the extent to which the GAAR can reach them in light of recent jurisprudence, including the Supreme Court's decision in *Shell Canada*;
- the tax policy concerns that are raised by monetization strategies, and the Supreme Court's approach to tax avoidance; and
- the policy concerns that are raised in other areas of law by monetization strategies, and the question whether the Supreme Court's approach to tax-avoidance transactions in a tax context may promote avoidance transactions in those other areas.

WHAT IS EQUITY MONETIZATION?

Introduction

The term "equity monetization" refers to the conversion of an equity position (generally, common shares) into cash. The simplest way to monetize shares is to sell the shares. However, the term is more commonly understood to refer to a transaction that allows an investor to receive cash in respect of an equity position by a means other than an outright sale, with a view to avoiding the tax costs (and perhaps certain non-tax costs and restrictions) associated with a sale.

Why Do Investors Enter into Monetization Transactions?

Investors monetize securities for the same reason that they sell securities: to obtain cash and to manage (that is, diversify) risk. The decision to monetize represents two separate decisions: a decision to exit a position, and a decision about the most desirable means of exiting a position. An investor with a concentrated block of publicly traded shares may be unwilling to tolerate the level of risk associated with that block of shares and may wish to diversify his or her holdings. If the investor is unable or unwilling to adjust the level of risk directly by selling some of the shares, he or she may seek to adjust the risk indirectly by monetizing the securities. When the desire to manage risk by means of portfolio diversification meets one or more "constraints," the investor will be pushed toward the alternative channel of monetization.

A Brief History of Monetization

Monetization strategies appear to have become widespread in the 1990s, following developments in financial theory[15] and in the sophistication of capital markets (for

---

15 Much of the modern theory of derivative-based financial products is based on the initial work of Fischer Black and Myron Scholes. See Black and Scholes, "The Pricing of Options and Corporate Liabilities" (1973) vol. 81, no. 3 *Journal of Political Economy* 637-54. This and other works are discussed, inter alia, in Tim Edgar, *The Income Tax Treatment of Financial Instruments: Theory and Practice*, Canadian Tax Paper no. 105 (Toronto: Canadian Tax Foundation, 2000), 23 et seq.

example, increased liquidity, which has allowed an industry relating to short selling to develop).[16]

The first reported monetization trade is thought to have occurred in 1994:

> The first such trade, an equity swap, was structured in 1994 by Michael Dweck, then at Bankers Trust, for the CEO of Autotote Corp., a New York-based company that provides pari-mutuel wagering equipment and services to racetracks and off-track betting facilities. After the CEO bought what amounted to an insurance policy on his personal chips, the price of the high-flying, volatile stock jackknifed. The effect was twofold: the deal kickstarted what is now a multibillion-dollar industry, and it launched what has turned out to be a resurgent anxiety about what needs to be disclosed and how the hedging activities of corporate insiders might affect the marketplace.[17]

As Bettis, Bizjak, and Lemmon note, although this is commonly cited as the first monetization trade, it seems likely that this was merely the first instance of a *reported* trade. There is some evidence that equity monetization trades have been around since at least the early 1980s.[18] In any event, there can be little question that by the mid-1990s these products made up a multibillion-dollar industry.[19] For example, in connection with monetization activity in the United States, David Schizer noted that

> [f]or individuals with positions worth less than $75 million, then, the relevant frictions usually are weak or malleable. As a result, over-the-counter hedging transactions are very common. The precise volume is difficult to ascertain, because these transactions are not publicly reported, and investment banks are secretive about their revenue sources. Yet in off the record conversations, private client services bankers at several of the leading players, as well as the smaller ones, suggest that the volume is extremely high, perhaps on the order of $150 billion a year or more.[20]

One reason for the phenomenal growth of such products is that before 1997, at least, such products created significant tax-deferral (and potentially tax-elimination)

---

16 See David M. Schizer, "Frictions as a Constraint on Tax Planning" (2000) vol. 101, no. 6 *Columbia Law Review* 1312-1409, at 1340.

17 J. Carr Bettis, John M. Bizjak, and Michael L. Lemmon, "Insider Trading in Derivative Securities: An Empirical Examination of the Use of Zero-Cost Collars and Equity Swaps by Corporate Insiders" (draft working paper, May 1999), 10 (available online at http://papers.ssrn.com). This paper is an earlier version of their 2001 article, infra note 35. The revised article makes brief reference to the Autotote monetization at 368.

18 Ibid.

19 See, for example, "Monetization Rule Backed—Said To Involve Billions," *National Post*, March 6, 2003. The Estée Lauder transaction alone is thought to have saved Estée Lauder $100 million in avoided taxes (see below). See also Jacquie McNish, "CIBC's Billion Dollar Stock Bonanza," *Globe and Mail*, August 3, 2002; this transaction was said to involve "one of the largest equity hedges ever negotiated in Canada."

20 See Schizer, supra note 16, at 1353.

opportunities in the United States. One notorious US example, which prompted the enactment of the Taxpayer Relief Act of 1997 (TRA)[21] in 1997, was the "short sale against the box" strategy employed by Estée Lauder in 1995.

The Estée Lauder "Short Sale Against the Box"

Before the TRA was enacted, a US security holder could, by means of a "short sale against the box," generate substantially the same cash flow that would have been generated by a disposition of securities while deferring (or in some cases eliminating) the recognition of the accrued gain for tax purposes. In 1995, Estée Lauder employed this strategy in connection with an initial public offering of stock by her company, Estée Lauder Companies, Inc., and is alleged to have realized tax savings in excess of US$100 million.[22] A trust, to which Estée Lauder had contributed all of her stock, made a secondary offering of 5.5 million shares in conjunction with the company's IPO. However, the shares offered by the trust were not beneficially owned by the trust; they had been borrowed from another stockholder (Estée Lauder's son, Leonard). The trust was required to close out the short sale, and return an equivalent number of borrowed shares, three days after demand. Security for the loaned stock (which had been sold pursuant to the public offering) was provided by means of a pledge of the stock held by the trust "in the box." For the duration of the borrowing, the trust was required to pay to the lender amounts equal to dividends and other distributions that would have been paid to the lender on the borrowed shares.

By means of this structure, the trust was able to achieve a significant tax deferral until the short sale was closed out, since it was well established (and accepted by the Internal Revenue Service [IRS]) that a short sale is not consummated until the short position is closed out (through the return of stock to the lender).[23] The deferral of tax continues so long as the short position remains open (that is, the stock lender does not call for the return of the stock). It seems unlikely that there was ever any expectation that the lender would call for the return of the stock (except upon the death of Estée Lauder). The structure of the loan of stock and the relationship of

21 Taxpayer Relief Act of 1997, Pub. L. no. 105-34, enacted on August 5, 1997, section 1001 (codified, as amended, at section 1259 of the Internal Revenue Code of 1986, as amended).

22 Susan M. Stone, "Deferring the Ultimate Makeover: Estée Lauder's IPO Makes Capitol Hill Look Twice at Short Sales Against the Box" (1997) vol. 14, no. 4 *Journal of Taxation of Investments* 356-66, at 358.

23 See Robert Willens, "TRA '97 Closes Loopholes for Tax Deferral and Conversions of Gains into Dividend Income" (1997) vol. 87, no. 4 *Journal of Taxation* 197-203, at 197. See also Steven D. Bortnick and Fredrica Hochman, "Computing Gain/Loss When an Estate Closes the Decedent's Short Sale" (1997) vol. 86, no. 5 *Journal of Taxation* 307-10, at 308; Peter L. Faber, Andrea S. Kramer, and William R. Pomierski, "The Ownership and Disposition of Property: New Rules for Old Problems" (1997) vol. 75, no. 12 *Taxes: The Tax Magazine* 768-87, at 782; and Schizer, supra note 16, at 1343.

the parties (parent and child) clearly indicate the substance of the transaction: a form of estate planning to facilitate an intergenerational transfer of wealth on a tax-efficient basis.

The deferral opportunity is not the whole story, however. As Robert Willens says,

> Moreover, given her advanced age, it seemed likely that Ms. Lauder had set her sights on a larger prize: permanent avoidance of the tax that otherwise would be due on the gain accrued through the date of the short sale. This objective, attainable if the short sale remained open on her death, was sanctioned by the conclusions expressed in Rev. Rul. 73-524, 1973-2 CB 307, which permits a "date of death value" basis step-up for the "long" side of a short against the box trade.[24]

This "larger prize" is available because the US tax code applies different basis treatment to a recipient of a gift, depending on whether the gift is an inter vivos gift or a gift received as a bequest or inheritance. Under section 1014 of the Code, property received as a bequest or inheritance receives a basis equal to the fair market value (FMV) at the date of death. In contrast, under section 1015, property received as a gift made in the donor's lifetime receives a basis equal to the donor's basis (and the donee may be taxed based on appreciation in value of the asset that occurred before the gift). As a consequence of the basis step-up in section 1014, accrued gains can permanently escape taxation.[25]

Estée Lauder, whose company in 1995 had net assets of $1.82 billion, was apparently able to defer $340 million in capital gains and to defer (and potentially avoid) over $100 million in tax.[26] The Estée Lauder transaction attracted considerable media attention.[27] The Clinton administration responded with proposed amendments to the Code in 1996; the proposals eventually led to the (somewhat narrower in scope) section 1259. That section is examined later in this article under the heading "The US Response to Equity Monetization."

---

24 Willens, supra note 23, at 197. See also Timothy R. Hughes, "Income Tax Implications of the Non-Dispositive Transfer of Equity Securities" (1999) vol. 57, no. 1 *University of Toronto Faculty of Law Review* 43-81.

25 The "basis step-up on death" rule, which "is widely acknowledged as a policy monstrosity" (Schizer, supra note 16, at 1367), is not an issue in Canada, because paragraph 70(5)(a) of the Act provides for a deemed disposition of capital property immediately prior to death. The status of section 1014 (the rule that provides for basis "step-up" on death) is somewhat uncertain at present. The rule is scheduled to be amended for transfers that occur after December 31, 2009. However, there is some question whether Congress will proceed with the proposed amendments. In addition, the amendments will automatically expire after one year unless the amendment is made permanent. See Schizer, ibid., at notes 109 and 198.

26 See Stone, supra note 22, at 357-58.

27 Willens, supra note 23, at 197. See also Faber, Kramer, and Pomierski, supra note 23, at 782; and Schizer, supra note 16, at 1343.

EXAMPLES OF MONETIZATION STRATEGIES

Equity Forward, Prepaid Forward, and Variable Delivery Prepaid Forward

One of the simplest ways to hedge a position is to enter into an equity forward contract. A forward contract is simply a contract for the exchange of one asset for another, with performance to occur at a future date. Assume, for example, that ABC Inc. is a public company. On January 1, 2001, John acquired 10 shares of ABC Inc. at an FMV price of $10 per share. On January 1, 2004, shares of ABC Inc. have an FMV of $100 per share. John does not want to sell the shares, but he is concerned that the shares might fall in value, and he wants to "lock in" at least $80 of the $90 accrued gain (that is, cash out at $90 per share.)

On January 1, 2004, John enters into a forward contract with InvestBank under which John agrees to sell, and InvestBank agrees to purchase, 10 shares of ABC Inc. at a price of $109.50 per share. The sale will take place on January 1, 2009. The parties may settle their obligations under the forward contract on a cash settlement basis or by physical delivery of 10 ABC Inc. shares. InvestBank hedges its risk under the forward contract through a dynamic hedging strategy involving short sales into the secondary market on and after January 1, 2004.

In this example, although John retains legal ownership of the 10 ABC Inc. shares that are the subject of the forward contract, he is no longer exposed to the risk that the share price may fall below the current FMV of $90.[28] Similarly, John is now indifferent to any appreciation in the value of the shares above this threshold, because any appreciation will accrue to the benefit (initially) of InvestBank.

The equity forward in the example is similar to a conventional sale in that John has divested himself of the economic incidents of ownership. However, the forward is unlike a sale in that John does not immediately receive any cash for the shares. (The shares have been hedged but not, strictly speaking, monetized.) If John wants to receive a cash amount, the forward can be structured as a "prepaid equity forward" or a prepaid variable delivery forward.[29] The prepayment element may be structured as a separate loan, or it may simply represent an upfront payment of the sale proceeds.

---

28 In economic terms, absent any consideration of taxes, and assuming an annual compounding of 4 percent, John and InvestBank are in the same position whether they proceed by way of a sale today at $90 or a sale five years from today at $109.50. In the case of a sale today, John receives $90, which he may then invest at 4 percent. Assuming an annual compounding return of 4 percent, at the end of five years, John will have received cash in the amount of $109.50. In the case of the forward sale at the end of five years, John will have received cash in the amount of $109.50:

End of year 1 (2004)	$90.000 \times 1.04 = 93.600$
End of year 2 (2005)	$93.600 \times 1.04 = 97.344$
End of year 3 (2006)	$97.344 \times 1.04 = 101.238$
End of year 4 (2007)	$101.238 \times 1.04 = 105.287$
End of year 5 (2008)	$105.287 \times 1.04 = 109.500$

29 For a discussion of prepaid forward contracts and prepaid variable delivery contracts, see generally D.L. Trier and L.W. Farr, "Constructive Sales Under Section 1259: The Best Is Yet

As noted above, the forward agreement effectively transfers the economic incidents of ownership from the investor to the lender. Although the investor has transferred exposure to risk and return to the lender (typically, an investment bank), the lender generally will seek to divest itself of this exposure through various hedging strategies (usually involving short sales in the secondary market.)[30]

Loan Combined with a Pledge of Securities

An alternative strategy for "monetizing" an equity position is to borrow funds and pledge the stock as security for the loan. However, the ability to borrow against an asset such as shares in a public company, absent anything further, is generally limited for two reasons. First, a simple pledge of shares may be of little interest to a lender as a form of collateral if the shares are highly volatile. Second, margin rules may limit the extent to which an investor can borrow against securities.[31] In the case of a simple pledge of securities, an investor's ability to borrow against the securities is typically limited to, say, 25 to 50 percent of the then-trading value of the share, combined with a requirement that exposes the investor to a margin call in the event that the value of the stock falls.

Accordingly, as a means of generating cash, a simple borrowing against public company stock suffers from two limitations:

- the security holder can borrow only a fraction of the amount that could be realized on a sale, and
- of the money that is advanced, some amount may have to be held in reserve by the borrower to cover a possible margin call.

Both of these limitations are driven by the risk that the value of the shares pledged as collateral may fall. By adding a hedging instrument, however, the holder is typically able to borrow anywhere from 75 to 95 percent of the value of the stock, depending on the structure.[32] In addition, because the risk that the value of

---

To Come" (2001) 518 PLI/Tax 509; and Faber, Kramer, and Pomierski, supra note 23, at 784. The variable delivery feature is used to avoid a characterization of disposition at common law and to avoid the application of section 1259.

30 See Schizer, supra note 16, at 1351-52: "Since the dealer is not in the business of betting on the market, the dealer must transfer this return to someone else, usually through short sales in the public markets." See also Michael R. Powers, David M. Schizer, and Martin Shubik, *Market Bubbles and Wasteful Avoidance: Tax and Regulatory Constraints on Short Sales*, Cowles Foundation Discussion Paper no. 1413 (New Haven, CT: Cowles Foundation for Research in Economics at Yale University, April 2003), 7.

31 For a discussion of margin rules in the United States, see generally Louis Loss and Joel Seligman, *Fundamentals of Securities Regulation*, 4th ed. (New York: Aspen, 2001), 803. See also Schizer, supra note 16, at 1351. See also Powers, Schizer, and Shubik, supra note 30, at note 9. For a discussion of margin rules in Canada, see generally Jeffrey G. MacIntosh and Christopher C. Nicholls, *Securities Law* (Toronto: Irwin Law, 2000), 98.

32 See Schizer, supra note 16, at 1351.

the collateral may fall has effectively been "carved away," the need to hold funds in reserve to cover a possible margin call is negated.

Combination of Secured Loan and a Put Option

The simplest form of hedging instrument in this example is a put option. An option may be viewed as a form of insurance. It confers upon the holder the right, but not the obligation, to purchase or sell an asset at a predetermined price (the exercise or strike price) over a given period.[33] A put option entitles the holder to sell an asset at a given price. A call option is an option to purchase an asset at a given price. By combining a secured loan with a put option that allows the security holder to put the stock pledged to the lender at, for example, 90 percent of its current trading price at the maturity date, the investor hedges his or her exposure to the risk that the value of the stock pledged will fall below that level. The only risk that the holder bears in respect of a fall in value below that level is the credit risk that the issuer (or "writer") of the option will be unable to perform his or her obligations under the contract.

Although the security holder receives cash up front in an amount comparable to that which would otherwise have been generated by a sale, the holder retains the potential for further upside gain in the stock. If at the term of the original loan (for example, after five years) the fair market value of the underlying stock has appreciated, the holder may simply repay the loan and request the return of the pledged stock.

Limited-Recourse Loan and Subordinated Full-Recourse Loan

In some cases, the put option will be evidenced by a separate over-the-counter (OTC) contract between the investor and the issuer of the option—typically, an investment bank. In other cases, the put option may be implicit in the terms of the loan arrangement itself. If the loan agreement is drafted as a limited-recourse loan agreement such that the lender's recourse on default is restricted to the securities pledged as collateral, the investor has effectively acquired a put option: the investor can effectively "put" the pledged securities to the lender to satisfy the debt. The limitation on recourse essentially represents an embedded put option. As in the previous example, the lender will engage in various hedging strategies in order to transfer this risk to other parties, such as investors in the secondary market.

A variation on the limited-recourse loan is the full-recourse loan made to a limited liability entity. For example, the investor may transfer the securities on a rollover basis to a newly created holding company, and the holding company will then enter into the loan agreement and pledge the stock. Although the loan is structured as a full-recourse loan as against the borrower, the limited liability nature of the direct borrower (the holding company) effectively immunizes the investor from exposure to the risk that the share price may fall.

---

33 The following discussion of options is drawn in part from the discussion contained in Edgar, supra note 15, at 14 et seq.

The Zero-Cost (or Costless) Collar

As noted above, a holder of public company securities may, through the combination of a secured loan and a put option, generate substantially the same level of cash that would be generated by an outright sale of such securities. However, there is obviously a cost associated with the purchase of the put option: the purchaser of the option will be required to pay compensation to the writer of the option—compensation that is essentially analogous to a premium for a share price insurance policy, which effectively "represents the cost of the price insurance that the option provides in respect of the specified asset."[34]

This cost may be substantially reduced or even eliminated if, at the time the investor purchases a put option, the investor simultaneously sells a call option and uses the proceeds from the latter to fund the former. By combining a put and a call (a technique sometimes referred to as a "married put and call"), the holder finances the purchase of the put option by forgoing the potential gains from any appreciation in the price of the underlying shares above the exercise price stipulated in the call option. The resulting combination of a put and call is also sometimes referred to as a "collar."[35]

An example[36] of a collar transaction (in which the investor retains some exposure to price movement) follows. Assume once again that ABC Inc. is a public company. On January 1, 2001, John acquired 10 shares of ABC Inc. at the FMV price of $10 per share. On January 1, 2004, shares of ABC Inc. have an FMV of $100 per share. John does not want to sell the shares, but he is concerned that the shares might fall in value, and he wants to "lock in" at least $80 of the $90 accrued gain (that is, "cash out" at $90 per share.)

On January 1, 2004, John purchases a put option from InvestBank and simultaneously sells a call option to InvestBank. The put option gives John the right, but not the obligation, to sell to InvestBank, at any time between January 1, 2004 and January 1, 2009, 10 shares of ABC Inc. at a price of $90 per share.[37] The call option gives InvestBank the right, but not the obligation, to require John to sell to InvestBank at any time between January 1, 2004 and January 1, 2009, 10 shares of ABC Inc. at $115 per share. The parties may settle their obligations under the contract on a cash settlement basis or by physical delivery of 10 ABC Inc. shares. John finances the purchase of the put option by the simultaneous sale of the call option. InvestBank hedges its risk under the put option through a dynamic hedging strategy involving short sales into the secondary market.

---

34 Ibid., at 14.

35 See the discussion in Edgar, ibid., at 16 et seq. See also J. Carr Bettis, John M. Bizjak, and Michael L. Lemmon, "Managerial Ownership, Incentive Contracting, and the Use of Zero-Cost Collars and Equity Swaps by Corporate Insiders" (2001) vol. 36, no. 3 *Journal of Financial and Quantitative Analysis* 345-70.

36 For a description of an actual collar transaction (involving a director of JDS Uniphase Corp.), see Weinberg, supra note 7.

37 For the sake of simplicity, I have ignored the time value of money aspect of this example.

The bands that make up the collar (that is, the range of movement in the underlying stock to which the holder remains exposed) will vary in accordance with the holder's needs. However, as the holder's degree of exposure to market fluctuations approaches nil, the collar increasingly begins to look like a sale. In these cases, the combination of a loan secured by a pledge of stock and a collar is sometimes referred to as a "synthetic"[38] sale, since the transaction generates a cash flow substantially similar to that generated by a sale. In the case of a "synthetic" sale involving a loan and a collar, the holder remains the registered holder of the securities and retains the right to vote the securities (to the extent that the securities carry a vote) and the right to receive dividends (to the extent that the securities carry a right to receive dividends). More importantly, the holder has been able effectively to exit his or her position without triggering immediate tax consequences, and potentially without attracting public or regulatory attention.

The Equity Swap

An alternative to a loan-plus-collar arrangement is an equity swap.[39] Assume, for example, that ABC Inc. is a public company. On January 1, 2001, John acquired 10 shares of ABC Inc. at the FMV price of $10 per share. On January 1, 2004, shares of ABC Inc. have an FMV of $100 per share. On January 1, 2004, John enters into a two-year swap agreement whereby he agrees to pay InvestBank at the end of years 1 and 2 an amount equal to dividends paid on the 10 shares of ABC Inc., plus any appreciation in value. In return, InvestBank agrees to pay John the London interbank offering rate (LIBOR) on a notional principal amount equal to the current value of the 10 shares of ABC Inc., plus any depreciation in value of the shares.

As Tim Edgar noted, the equity swap described above provides "the same ability to monetize the gain without entering into a share transfer that results in a disposition and a realization event for income tax purposes."[40] Although John does not receive $100 per share at the outset of the arrangement, he has protected his gain of $90 per share (and thereby created a secure basis against which to borrow, if need be). For the two-year period, he has divested himself of the economic attributes of ownership of the asset. John has forgone the benefit of any appreciation in the value of the shares over this period and the dividend stream generated by the shares. The risk of any fall in value of the shares is now borne by InvestBank. At the end of the two-year period, John will have received the same cash flow that he would have received if he had sold the 10 shares (in a taxless world) and invested the proceeds of $1,000 in an instrument bearing interest at the LIBOR rate.

---

38 Tim Edgar defines "synthetic" as follows: "Synthetics combine two or more legally distinct instruments in order to replicate the cash flow pattern associated with another legally distinct instrument." Edgar, supra note 15, at 68.

39 This example and the accompanying analysis are based on an example and analysis prepared by Edgar, ibid., at 321.

40 Ibid., at 328.

The "Short Sale Against the Box"

A variation on the synthetic sale is the "short sale against the box."[41] Perhaps the most notorious example of this type of transaction is the Estée Lauder transaction, briefly described earlier, which led to amendments to the US Internal Revenue Code that effectively foreclosed this strategy in the United States. Tim Hughes has described the "short sale against the box" strategy as follows:

> A shareholder sells short against the box when he or she holds both a short and long position in an identical number of the same security. That is, the shareholder borrows shares to effect a short sale, but already owns the shares that can be used to close out the short position. The "box" is a reference to the safe deposit box in which the taxpayer is presumed to hold the securities that make up the long position.[42]

Assume, for example that ABC Inc. is a public company.[43] On January 1, 2001, John acquired 10 shares of ABC Inc. at the FMV price of $10 per share. On January 1, 2004, shares of ABC Inc. have an FMV of $100 per share. On January 1, 2004, John borrows 10 ABC Inc. shares from InvestBank and sells them for a price equal to their market value of $1,000. Under the terms of the securities lending agreement with InvestBank, John is required to return the borrowed shares on January 1, 2009. John also agrees to pay InvestBank an amount equal to dividends paid on the ABC Inc. shares during the term of the loan. He posts his block of shares as collateral for his obligations.

Had John sold the original block of shares, John would have realized proceeds of disposition of $1,000 and a capital gain of $900 (the proceeds of disposition less the adjusted cost base of $100). Since January 1, 2001, a taxpayer has been required to include one-half of a capital gain—in this case, $450—in income as a taxable capital gain. If we assume (for the sake of simplicity) that John's taxable capital gain is taxed at a marginal rate of 50 percent, the sale will generate a tax liability of approximately $225.

By means of the transaction described above, however, John appears to be able to generate substantially the same cash flow that would have been generated by a sale of his original block of shares while deferring the recognition of at least part[44] of the accrued gain for tax purposes.

---

41 Ibid., at 326 et seq. See also Hughes, supra note 24; and Stone, supra note 22.

42 Hughes, supra note 24, at 58. A numerical example, with analysis, is provided at Edgar, supra note 15, at 327-28.

43 This example and the accompanying analysis are based on an example and analysis prepared by Edgar, supra note 15, at 326.

44 As explained by Edgar, ibid., at 327, the above example would probably generate a complete deferral of tax only in those jurisdictions, such as the United States (prior to 1997), that allow a taxpayer to identify which securities (among various securities with differing cost bases) are disposed of. In certain jurisdictions, including Canada, the existence of an average cost rule for identical securities likely would mean that the deferral is a partial deferral only. A discussion of

Without selling the original shares, John has replicated the transfer of risk and return that would have resulted from a sale. He has also effectively divested himself of the benefits of any future return from the shares. John is no longer exposed to the risk that the original block of shares may fall in value. Any fall in the value of his original block of shares will be matched by a corresponding fall in the cost to him of complying with his obligation to deliver an equivalent number of shares to InvestBank on January 1, 2009. Any appreciation in the value of his original holding will be matched by a corresponding increase in the cost to him of complying with his obligation to deliver a like number of shares to InvestBank on January 1, 2009. In other words, John has locked in the $900 accrued gain and has insulated himself against future fluctuations in the value of the shares by creating offsetting long and short positions. Similarly, any dividends he receives on the original block of shares will be offset by a corresponding obligation to pay over dividends to InvestBank during the term of the loan. The example appears to permit at least a partial deferral of the tax on the $900 capital gain, since it replicates the cash flows generated by a sale, but it arguably does not give rise to a "realization" event. As Edgar explains,

> Although [John] has realized the [$900 value of his ABC Inc. shares] as proceeds that he can invest for the period of the short sale, it is arguable that a strict adherence to legal form as a proxy for a disposition provides the benefit of the deferred recognition of any gain. . . . [T]he fact that [John] retains the right to satisfy his obligation under the securities loan with shares subsequently acquired in the market negates any presumption (at least at the time of the short sale) that the identical property he holds "in the box" is, in fact, the property sold. Until identifiable shares are transferred in satisfaction of the short sale and related securities loan, a strict adherence to legal form as a proxy for a disposition means that the [$900] accrued gain is unrealized. In effect, [John] has "monetized" that gain without attracting a realization event.[45]

Exchangeable Debentures

The exchangeable-debenture structure is essentially a variation on the earlier example of a secured loan plus collar (with an identical strike price for the put and call components of the collar). Assume, for example,[46] that ABC Inc. is a reporting issuer. On January 1, 2001, John acquired 10 shares of ABC Inc. at the FMV price of $10 per share. On January 1, 2004, shares of ABC Inc. have an FMV of $100 per share. On January 1, 2004, John transfers on a rollover basis the 10 ABC Inc. shares to a wholly owned holding company, Holdco. Holdco subsequently issues exchangeable debentures to InvestBank on a private placement basis. The aggregate principal

---

the average cost rule is beyond the scope of this paper. For a discussion of this rule, see Edgar, ibid., at 327-28.

45 Ibid., at 327.

46 For a description of an actual exchangeable-debentures transaction (involving shareholders of Bombardier), see Fabrice Taylor, "Bombardier Deal Kept Investors in the Dark," *Globe and Mail*, March 10, 2003.

amount of the exchangeable debentures is an amount equal to $900. The debentures are for a term of 10 years.

The debentures are exchangeable, at the option of the debenture holder, InvestBank, into 10 ABC Inc. common shares or, at the option of Holdco, into the cash equivalent of 10 ABC Inc. shares based on the FMV of 10 ABC Inc. shares at the time of the exchange. The debentures are redeemable at any time by Holdco. Upon redemption, Holdco may at its option repay the principal amount of the debentures by delivering 10 ABC Inc. shares or the cash equivalent of 10 ABC Inc. shares based on the FMV of 10 ABC Inc. shares at the time of the exchange. Holdco pledges the 10 ABC Inc. shares to InvestBank to secure its obligations upon any exercise of the debenture holder's exchange right.

John has indirectly received proceeds in the amount of 90 percent of the FMV of the 10 ABC Inc. shares. These proceeds have the legal character of loan proceeds since, in theory, there is an obligation to repay these loan proceeds at the term of the 10-year loan. However, the exchange feature of the debentures essentially transfers the risk of loss and the opportunity for gain to InvestBank. If the share price falls below $90, Holdco can put the 10 ABC Inc. shares to InvestBank to settle Holdco's obligations under the debentures. If the share price rises above $90, InvestBank will exercise its right to take the 10 ABC Inc. shares in lieu of a repayment of the principal amount of the debentures.

More Exotic Species

The examples given above represent monetization strategies in some of their simpler forms. In recent years, numerous varieties of more exotic species have proliferated in the United States, including DECS trust units,[47] STRYPES,[48] Feline PRIDES,[49] and SAILS.[50] A consideration of such structures is beyond the scope of this article.

WHY ARE MONETIZATION TRANSACTIONS ATTRACTIVE?

In many cases, the principal factor that steers an investor to a monetization alternative is the tax consequences associated with a sale. In some cases, the investor may want to avoid other costs or restrictions (for example, securities law restrictions or contractual restrictions) that may apply to a sale, in the belief (not necessarily

47 Hughes, supra note 24, at 73. DECS (or debt exchangeable for common stock), a form of equity derivative, is a service mark of Salomon Brothers, Inc. See also the discussion of DECS trust units in Schizer, supra note 16, at note 146; and Lee A. Sheppard, "No Constructive Sale in a DECS Transaction" (2003) vol. 98, no. 5 *Tax Notes* 649-52.

48 STRYPE (structured yield product exchangeable for stock) is a retail version of DECS. See Sheppard, supra note 47, at 649.

49 Forward contract and note issued as a single unit. See the discussion in Schizer, supra note 16, at 1330 et seq.

50 Stock appreciation income-linked securities. See Willens, supra note 23, at 197.

correct) that a monetization strategy allows for the avoidance of such costs or restrictions. The following comparison of cash flows associated with a conventional sale and a monetization illustrates the potential for significant tax savings in the case of the latter.

Facts

Assume that ABC Inc. is a public company listed on the Toronto Stock Exchange. On January 1, 2001, John acquired 10 shares of ABC Inc. at the FMV price of $10 per share. On January 1, 2004, shares of ABC Inc. have an FMV of $100 per share. John is concerned that the shares might fall in value, and wants to convert his shares into cash.

Tax Consequences Associated with a Conventional Sale

If John sells his shares on January 1, 2004, the sale will trigger a capital gain of $900, and John will incur a tax liability in the year of the disposition. Assuming that the capital gains inclusion rate is 50 percent,[51] John has a taxable capital gain of $450. If John's marginal tax rate for this income item is 50 percent, then his tax liability on the disposition, in the year of disposition, will be approximately $225. After payment of the tax, therefore, John is left with approximately $775 ($1,000 less $225 in tax) for further investment and/or consumption. (For simplicity, this example assumes that there are no transaction costs.)[52]

If we assume that the $775 in after-tax proceeds is reinvested in an income-earning asset that yields a 10 percent return, then the asset will yield $77.50 per year,[53] which in turn should attract a further tax liability of approximately $38.75 per year. At the end of five years, John will have after-tax proceeds of $775 + (5 × $38.75), or $968.75.

---

51 The capital gains inclusion rate has bounced around somewhat in recent years. Before 1972, capital gains were excluded from income. In more recent years, the rate has varied from ½ (for years prior to 1988) to ⅔ (for 1988 and 1989) to ¾ (for 1990 to part of 2000) to ⅔ (for part of 2000) to ½ (for 2001 to date).

52 Like the transaction costs associated with a monetization, the expenses of disposition are here assumed to be nil to allow an easier comparison of tax costs. Owing to the transaction costs associated with such structures, it is likely the case that most retail investors will not see any advantage in engaging in a synthetic sale. The development of such products has been driven by high-net-worth investors with significant equity positions who are subject to significant "constraints" on their ability to trade. However, it is worth noting that, as such products have become more widely available, transaction costs appear to be coming down substantially. See Mehta, supra note 7. David Schizer notes that, in the United States, "individuals with positions worth between $1 million and $75 million . . . have become the core clientele of a thriving hedging industry." See Schizer, supra note 16, at 1347. In the United States, some firms will arrange for positions as small as $100,000 to be hedged. Ibid., at notes 119 and 123.

53 This example assumes that the interest income is not otherwise sheltered, and that the after-tax yield is not reinvested, such that the annual return is then compounded.

Tax Consequences of a Monetization

If John structures the sale as a synthetic sale, then he should be able to generate substantially equivalent cash flows without incurring an immediate tax liability. The tax liability will be deferred through the conversion of an economic disposition from a realization event, for tax purposes, to a non-realization event. (For the purposes of this example, the transaction costs are again omitted to facilitate the comparison of tax consequences.)

The Forward

John enters into a five-year forward with a financial institution and agrees to sell (and the financial institution agrees to buy) the shares for $1,216 on January 1, 2009 (the forward maturity date).[54] John has thus effectively transferred the risk of any fall in value of the shares between now and the forward maturity date to the financial institution, because the financial institution is committed to taking the shares at the price of $1,216 in 2009 regardless of the FMV at that time. Similarly, any further appreciation in the value of the shares will be for the benefit of the financial institution (if it chooses to retain the risk of loss and opportunity for profit associated with the shares).

The Pledge of Shares

By means of the forward, John has locked in his gain without disposing of the shares and without triggering a realization event for tax purposes. Technically, the disposition has been deferred to 2009. Without a disposition, there are no proceeds of disposition. Without proceeds of disposition, there is no capital gain. However, although John has divested himself of the exposure to future movements in the share price, he has received no cash from the transaction. The timing of the receipt of cash remains linked to the disposition in 2009.

John can advance the receipt of cash by combining the forward with a loan secured by a pledge of shares. Because John is no longer exposed to the risk that the shares may fall in value, he is able to borrow up to 95 percent of the FMV of the shares. Accordingly, he can secure loan proceeds of approximately $950. The term of the loan coincides with the term of the forward. Because proceeds from a loan do not ordinarily[55] constitute income, John will receive the $950 loan proceeds free of tax.

54 In economic terms, absent any consideration of taxes, John (and the counterparty) are in the same position whether they proceed by way of a sale today or a sale five years from today. In the case of a sale today, John receives $1,000, which he may then invest. Assuming an annual compounding return of 4 percent, at the end of five years, John will have received cash in the amount of $1,216: $1,000 (in 2004) + $40 (in 2005) + $41.60 (in 2006) + $43.26(in 2007) + $44.99 (in 2008) + $46.79 in (2009) = $1,216.64.

55 A loan generally does not constitute "income" for the purposes of the Income Tax Act because in theory a loan does not represent a source of income to the borrower. There is, in theory, no change in the borrower's economic position. At the time the borrower receives cash (an asset) the borrower incurs a corresponding debt (a liability). Proceeds of a loan may come to constitute

If John invests the $950 in loan proceeds in an income-producing asset that yields, for example, a 10 percent return, then the asset will yield $95 per year. (This assumes that the income is not reinvested.) During the term of the loan, John is required to pay interest at, in this example, 4 percent per annum, or $38. After deduction of this interest expense, John has a net taxable income of $57, which (assuming a marginal tax rate of 50 percent) will attract a tax liability of $28.50.

At the end of five years, John settles the forward. John (notionally) delivers the pledged shares (or identical shares swapped for the pledged shares, or the cash equivalent of the shares) to InvestBank, and InvestBank (notionally) delivers the proceeds of $1,216 under the forward agreement to John. John uses the proceeds to repay the loan of $950. John has a capital gain of $1,116 ($1,216 − $100), a taxable capital gain of $558 ($1,116 × 50%), and a tax liability of $279 ($558 × 50%). At the end of five years, John has after-tax proceeds of $1,079.50 ((5 × $28.50) + ($1,216 − $279) = $142.50 + $937).

In summary, in the first example, John divested himself of all of his economic interest in the ABC Inc. securities and received a cash amount equal to 100 percent of the FMV of the securities in the form of "proceeds of disposition." In the second example, John divested himself of all of his economic interest in the ABC Inc. securities and received a cash amount equal to 95 percent of the FMV of the securities in the form of loan proceeds. In the first example, John faced an immediate tax liability in the year of disposition (2004). In the second example, since the cash obtained is considered, as a matter of legal form, to be proceeds from a loan, there are no tax consequences until January 1, 2009. In the first example, John's after-tax proceeds in 2009 are $968.75. In the second example, John's after-tax proceeds are $1,079.50. While the simplifying assumption of no transaction costs exaggerates the apparent tax savings in the second example, the tax savings may be magnified if the 10 percent yield in the example is reinvested or the terms of the forward and the loan are extended.

WHY ARE MONETIZATIONS SUCCESSFUL FROM A TAX PERSPECTIVE?

In the previous section, we considered how an investor can achieve a significant tax deferral, and ultimately significant tax savings, by structuring a disposition (in

---

income in certain circumstances—for example, where a loan is forgiven. Although the loan will not trigger tax consequences, tax consequences will usually be associated with the acquisition or disposition, as the case may be, of a put, call, or collar. The acquisition or disposition of a put, call, or collar may result in a gain or loss to the investor, depending on the value of the derivative and the value of the underlying asset. These gains and losses can be on either the income account or the capital account, depending on the nature of the transaction. For reasons of space, I have omitted a discussion of the tax treatment of options. This discussion is fully set out by Steven Baum, Michael G. Quigley, and Deborah Toaze, "Nuts and Bolts of Derivatives," in *Tax Effects of Financial Transactions and Operations: Update on Taxation of Financing Structures and Transactions* (Toronto: Infonex, 2000), section 2.

economic terms) as a monetization instead of an outright sale. This section considers why these strategies are successful from a tax perspective.

Dependence on Legal Form

Equity monetization strategies allow an investor to transfer the economic risk and return associated with an asset without transferring the legal and beneficial ownership of the asset.[56] Such products represent a market recognition of, and a response to, the fact that income tax legislation generally attempts to regulate changes in an investor's economic interest in an asset by regulating the investor's beneficial ownership of the asset. This focus on form is based on two key assumptions:

> [F]irst, that the essence of a disposition is the transfer of risk associated with an asset; and, second, that transfer of the ownership of an asset as a matter of private law is an accurate proxy for changes in risk. The transfer of an asset in the form of a sale is thus considered the core element of a disposition.[57]

As a consequence of the dramatic growth in the use of derivative-based financial instruments over the last 25 years or so, these assumptions simply no longer hold true. Rather, as Edgar puts it,

> [the] reliance on legal form is confounded rather easily by the use of derivative instruments to create various long and short positions (1) to disguise . . . amounts equivalent to interest as . . . gain realized on the disposition of an asset, (2) to transfer risk without legal transfer, or (3) to retain risk even after legal transfer.[58]

Legislative regimes that focus on ownership and changes in ownership of an asset are easily "confounded" as a result of developments in financial theory over the last 30 years.[59] Modern financial theory recognizes that financial equivalents to an ownership position, or the acquisition or disposition of an ownership position, can be created through a combination of basic "building blocks" and long and short positions in the relevant asset. Because these basic principles of financial equivalencies are not recognized by legislative regimes, investors are presented with significant arbitrage opportunities.

Monetization as Tax Arbitrage

Edgar describes "tax arbitrage" as follows:

56 Edgar, supra note 15, at 325 et seq.

57 Ibid., at 325.

58 Ibid., at 317.

59 Much of the modern theory of derivative-based financial products is based on the pioneering work of Black and Scholes (supra note 15). Their work and other publications based on it are discussed, inter alia, in Edgar, supra note 15, at 23 et seq.

> "[T]ax arbitrage" refers loosely to any repackaging of cash flows in an effort to obtain a tax benefit or a lower tax burden. In this sense, the term is tantamount to "tax avoidance" viewed broadly as the rearrangement of any transaction to minimize tax payable or otherwise obtain a tax benefit. Within the narrower financial context, tax arbitrage entails a process that is very similar to regulatory arbitrage. In particular, the process depends on differences in tax treatment, which . . . encompass differences in tax rates for different sources and uses of funds. These differences in tax treatment provide taxpayers with opportunities to alter the form of cash flows in a manner that lowers the associated tax burden without altering the desired pattern of those cash flows. In some instances, the arbitrage is structured to take advantage of differences between the tax treatments for equivalent cash flows. In other instances, the arbitrage is structured to take advantage of circumstances in which minor changes in the pattern of cash flows result in significant changes in tax treatment.[60]

Opportunities for tax arbitrage arise in the Canadian federal income tax system because the system makes a number of important distinctions between different types of cash flows. The most important differences are

- different tax treatment for income and capital,
- different tax treatment for interest and dividends, and
- the recognition of some economic gains and losses on an accrual basis and other gains and losses on a realization basis.[61]

The first two elements relate to the character of the economic gain, and the last relates to the timing of the gain. Generally speaking, equity monetization strategies focus on the last, and attempt to produce the cash that would be generated by a realization event (such as a disposition) by a means other than a realization event (such as a monetization).[62] The realization principle is briefly considered next.

The Realization Principle

The realization principle is a fundamental feature of the Canadian income tax system: economic gains do not constitute "income," and are therefore not subject to a tax on income, unless and until they are "realized" (that is, crystallized or in some manner made permanent). Douglas Sherbaniuk summarized the realization principle:

---

60 Ibid., at 30.

61 Ibid., at 33. See also Tim Edgar, "Some Lessons from the Saga of Weak-Currency Borrowings" (2000) vol. 48, no. 1 *Canadian Tax Journal* 1-34, at 4; and Tim Edgar, "The Tax Treatment of Interest and Financing Charges in a World of Financial Innovation: Where Should We Be Going?" in *Current Issues in Corporate Finance*, 1997 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1998), 10:1-57, at 10:10.

62 In addition, as noted earlier, monetization strategies in the United States also attempt to exploit the "basis step-up on death" rule. See Schizer, supra note 16, at 1367.

> Although the income tax laws of [Canada, the United States, and the United Kingdom] differ markedly in many material respects, common to all of them is the fundamental principle that only "realized" gains are taxable as income. That is to say that, speaking generally, tax is imposed only on actual gains, and not on deferred or potential or anticipated gains such as an appreciation in value of a taxpayer's stock-in-trade or his right to receive salary or interest, for example, even though these items enhance his economic worth. As will be explained in detail below, under the early income tax laws of the United Kingdom, the United States and Canada, as a general rule income was regarded as arising when it was received and not before, "receipt" being the fruition or realization in possession of a potential or anticipated gain. This approach contemplated the computation of income on the "cash receipts and disbursements" method of accounting, according to which only amounts actually received and actually paid by the taxpayer are taken into account.[63]

Sherbaniuk also summarized the arguments that have traditionally[64] been advanced to support the realization principle:

> Several reasons may be advanced in support of a proposition that income arises when it is received. For one thing, the idea of a "coming in" or receipt is implicit in the term "income," and for another, the recognition of income when it is reduced to possession by the taxpayer and is available to satisfy his wants and desires would accord with the layman's understanding of that word. This is an important practical consideration in view of the fact that most taxpayers compute and report their own income. Applicable equally to the United States and Canada as to the United Kingdom is the statement made recently in the House of Lords that "much of the effective administration of Revenue Collection will continue to depend, as it always has, upon the measure of candour and responsibility that is shown by the individual taxpayer and his professional advisers." It follows that if a taxpayer can readily determine when his income arises to be taxed by the application of some simple, objective standard such as receipt, as contrasted, say, with having to make complete periodical revaluations of all his property, as Haig[65] would have him do, the more likely is his return to be complete and accurate, and the less burdensome the taxing authority's task of revenue collection. More important, the imposition of tax only on gains which

63 D.J. Sherbaniuk, "Receipt and the Time of Recognition of Income: A Historical Conspectus of the Income Tax Laws of the United Kingdom, the United States and Canada" (1963) vol. 15, no. 1 *University of Toronto Law Journal* 62-101, at 64-65. This passage is discussed in Douglas S. Ewens and Michael J. Flatters, "Toward a More Coherent Theory of Dispositions" (1995) vol. 43, no. 5 *Canadian Tax Journal* 1377-1411, at 1379.

64 Similar arguments have been used to justify the realization principle in the United States. See Faber, Kramer, and Pomierski, supra note 23, at 777.

65 The realization principle may be contrasted with the accretion-to-wealth concept of income developed by Henry Simon and Robert Haig. In the 1930s, Henry Simon, building on prior work by Robert Haig, defined income as essentially the sum of an individual's accumulation plus consumption over a given period. This definition, commonly referred to as the Haig-Simons definition of income, has been widely accepted by economists and scholars as the most principled and meaningful definition of income.

> have been received "does mathematical justice between government and taxpayer" and fairly reconciles their opposing interest in that the latter is spared unnecessary hardship if collection of the tax is postponed until he has received the income out of which to pay it, and the revenue authority is adequately protected if tax is levied at this time when the taxpayer is in funds. Finally, at the time of receipt the uncertainty that amounts due might not be paid is eliminated and the amount of the taxpayer's gain may be accurately ascertained.[66]

Thus the traditional[67] arguments in favour of a realization principle are essentially as follows:

- A realization principle is arguably implicit in the concept of "income."
- Taxpayers are most likely to find a realization principle legitimate, because it accords with a lay person's understanding of "income." This perceived legitimacy promotes compliance, which is essential in a tax system based on self-assessment.
- A realization principle is simpler to administer than a system that requires periodic assessments of market value. This simplicity should promote compliance and reduce the cost of administering the system.
- A realization-based system is fair, because the liability for tax is postponed until the taxpayer has received the income out of which to pay it.
- A realization-based system allows for greater certainty because the amount of the taxpayer's gain can be accurately ascertained.

These arguments have found wide acceptance in Canadian jurisprudence, including decisions of the Supreme Court of Canada.[68] As Brian Arnold has noted,

> The requirement that income be realized is well established as a fundamental principle of income taxation in the jurisprudence of the United Kingdom, the United States, and Canada. Potential, anticipated, or expected profits are not subject to tax until they have been realized. In the English case of *Ostime v. Duple Motor Bodies Ltd.*, Lord Reid stated that ". . . [it] is a cardinal principle that profit shall not be taxed until realized; if the market value fell before the article was sold the profit might never be realized." Similarly, in the Canadian case of *MNR v. Consolidated Glass Co. Ltd.*, Rand, J. said,

66 Sherbaniuk, supra note 63, at 65-66.

67 More recently, David Schizer has argued that the realization principle can be explained as a form of subsidy to encourage savings. See David M. Schizer, "Realization as Subsidy" (1998) vol. 73, no. 5 *New York University Law Review* 1549-1626. For a discussion of arguments traditionally advanced against the realization principle, see the same article at 1551-52.

68 See, for example, *Robertson v. Minister of National Revenue* (1944), 2 DTC 655 (Ex. Ct.); *MNR v. Consolidated Glass Company Ltd.*, 56 DTC 1035 (SCC); and *Ikea Limited v. The Queen*, 98 DTC 6092 (SCC). See also the discussion in Ronald S. Wilson, "Arbitrage Trading," in *Report of Proceedings of the Fifty-Second Tax Conference*, 2000 Conference Report (Toronto: Canadian Tax Foundation, 2001), 23:1-31, at 23:14.

> . . . [H]ow can profits and gains be considered to have been made in any proper sense of the words other than by actual realization? There is no inventory feature in relation to capital assets. That the words do not include mere appreciation in capital value is, in my opinion, beyond controversy.[69]

Implicit in the realization principle is the idea that an accrued but as yet unrealized gain is “contingent.” Because the gain is not yet assured, it cannot easily be determined. Because it cannot yet be determined (and may never arise), it is premature to recognize the gain for the purposes of establishing a liability for tax in connection with the gain.

The treatment of contingent gains may be contrasted with the general treatment of gains (such as “interest”) that are considered fixed:

> In the simplest sense, fixed amounts are taxed as they accrue or are earned, on the basis that the taxpayer is entitled to enforce the payment of such amounts. Contingent amounts are amounts on which the return is not fixed. These amounts are not recognized or taxed until an event occurs which makes it certain that an amount will be realized (earned). Thus, a gain or loss from acquiring and holding a share of a corporation is not recognized until the gain or loss is realized, usually as a result of a sale or some other method of realization.[70]

The distinction in treatment between “contingent” and “fixed” (or “expected” and “unexpected”) gains can be easily exploited by means of financial instruments. Through the use of options, for example, an uncertain return can be converted into a certain return. The combination of a secured loan and a put option provides for both certainty and a source of cash that approximates the cash that would be received if the securities were sold.

Once an uncertain gain has been rendered certain, virtually all of the arguments for realization treatment fall away, at least to the extent of the gain. For example, where an investor holds a security with an acquisition cost of $10 and an accrued but as yet unrealized gain of $90 (such that the current value of the security is $100), Lord Reid’s classic statement, quoted above, seems appropriate: “[It] is a cardinal principle that profit shall not be taxed until realized; if the market value fell before the article was sold the profit might never be realized.” If the investor acquires a put entitling the investor to sell the security at, for example, $100, the investor has locked in that gain. The contingent return has been fixed at *at least* $90. There may be a continued justification for continued income deferral through realization treatment

69 B.J. Arnold, *Timing and Income Taxation: The Principles of Income Measurement for Tax Purposes*, Canadian Tax Paper no. 71 (Toronto: Canadian Tax Foundation, 1983), 127-28. This excerpt is considered in Tom Clearwater, “The Judicial Role in Derivative Taxation: The Queen v. Shell Canada Limited and Financial Contract Economics” (1998) vol. 46, no. 6 *Canadian Tax Journal* 1212-44, at 1221.

70 Ewens and Flatters, supra note 63, at 1380.

to the extent that there is possible gain over and above $90. There is little or no justification for continued realization treatment for the now-fixed $90 gain.

In other words, hedging or monetization should be understood as a form of realization. In fact, "equity monetization" and "equity realization" could almost be synonyms, in that they both essentially refer to the conversion of equity into cash. The concept of realization should in theory have as little difficulty in reaching an investor who cashes out by means of a monetization as it does an investor who cashes out by means of a sale.

In practice, however, the widespread use of monetization strategies to achieve significant tax deferrals suggests that practitioners and investors view monetization strategies as an effective way to realize a gain without the act being formally recognized as a realization event. Historically, the concept of realization has been tied to a sale or other form of disposition of the *appreciated securities*. In the case of a monetization, a taxpayer is able to argue that there has been no actual dealing in the appreciated securities. There is no formal legal connection between the monetization arrangement and the securities. The taxpayer still owns the securities and, if the securities are viewed in isolation, remains fully exposed to the risk of loss and opportunity for profit associated with the securities. Thus, the taxpayer is able to assert that entering into a monetization arrangement does not, as a matter of legal form, constitute a "disposition" of the appreciated securities. The question of whether the tax authorities and the courts will accept this argument is considered next.

The Meaning of "Disposition" in the United States

In the United States, if the owner of an asset transfers some or all of the incidents of ownership of that asset to another person, the owner may be viewed as having disposed of that asset for tax purposes, and the transferee of such incidents may be viewed as having acquired tax ownership of the asset.[71] Consequently, even before any consideration of the constructive sale rules in section 1259 of the Internal Revenue Code (discussed later in this article), an investor who seeks to monetize securities must first consider whether the monetization will trigger a deemed disposition of the underlying securities at common law.

Harmon and Breen describe the general principles that should be considered in determining whether a hedging transaction will be considered a disposition for tax purposes under common law:

71 See, for example, Mary L. Harmon and Daniel P. Breen, "A Practical Guide to Equity Monetization," in *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings*, Tax Law and Estate Planning Course Handbook Series (New York: Practising Law Institute, 2001), 823-47, at 831. See also Trier and Farr, supra note 29; Faber, Kramer, and Pomierski, supra note 23, at 782; Schizer, supra note 16, at note 98; and Edward D. Kleinbard, "Risky and Riskless Positions in Securities" (1993) vol. 71, no. 12 *Taxes: The Tax Magazine* 783-99.

> The initial tax issue that an investor must confront when hedging an investment with an equity derivative is whether the transaction will result in a deemed disposition of the underlying investment for tax purposes. It is clear that a simple forward contract or option on stock (unless extremely deep-in-the-money) will not trigger a common law disposition of the underlying stock. There is no direct guidance specifically dealing with this issue in the context of an equity collar, but the widely-held belief is that entering into an equity collar to hedge a stock position will not result in a disposition of the underlying stock.
>
> Traditional principles of tax law regarding who bears the benefits and burdens of ownership should be analyzed to determine if a particular transaction results in a disposition. This is a facts and circumstances determination with the relevant factors being: (1) who bears the downside risk and who stands to benefit from the upside potential; (2) who has actual control over the property during and after the period that it is hedged; (3) whether the credit risks inherent in the collar differ greatly from those of a mere equity owner; and (4) whether the investor retains the right to vote the shares. Thus, even though no law is directly on point, a taxpayer can structure an equity collar in a way to ensure that the risk of a deemed disposition should be minimal. On the other hand, if the transaction taken as a whole looks more like an actual sale of the underlying stock dressed up as an equity collar, the taxpayer may be considered to have disposed of the underlying stock.[72]

Exactly when a hedging transaction results in a sale of the underlying asset remains somewhat uncertain at common law. There is some case law on the concept of "tax ownership" (generally in relation to non-fungible property, such as real estate or tangible personal property) that suggests the courts may be prepared to take a broad substance-over-form approach.[73] The recent high-water mark for a substance-over-form analysis of a stock hedge is found in a December 2000 field service advice issued by the IRS.[74] In this FSA, the IRS determined that certain taxpayers who had entered into a variable delivery forward contract (albeit with certain unique features) had disposed of their stock. The IRS did not analyze the transaction under the Code's section 1259 constructive sale rules because the transaction in question predated those rules.

More recently, however, it appears that the IRS has retreated somewhat from this position (to the relief, no doubt, of many investors and their advisers). In Revenue ruling 2003-7,[75] the IRS concluded that a receipt of cash on a pledge of shares in connection with a three-year variable delivery contract did not constitute

72 Harmon and Breen, supra note 71, at 830-31 (footnotes omitted). See also Trier and Farr, supra note 29; and Faber, Kramer, and Pomierski, supra note 23.

73 See, for example, the discussion in Faber, Kramer, and Pomierski, supra note 23, at 770.

74 Field Service Advice 200111011, December 6, 2000 (hereinafter, "the December 2000 FSA"). This FSA is discussed, inter alia, at Trier and Farr, supra note 29, at 516; and Schizer, supra note 16, at note 98.

75 Rev. rul. 2003-7, 2003-5 IRB 363.

a constructive sale of those shares at common law. The IRS based its determination in large part on the fact that the taxpayer was legally entitled to reacquire the pledged securities by substituting other identical securities or cash and was not "economically compelled" to deliver the pledged securities.

Although some practitioners have questioned the correctness of the December 2000 FSA,[76] Revenue ruling 2003-7 has also come under heavy criticism. As Lee Sheppard has written,

> By relying on old case law that hinges on the identification of shares, Rev. Rul. 2003-7 gives undue credence to the share identification fiction in the face of the reality of fungible shares traded in public securities markets. . . .
>
> Should it matter that pledged publicly traded securities might be fungible with zillions of other identical shares that the investment bank that is the counterparty might be holding in inventory? Not while the law still permits the taxpayer to identify shares.
>
> Here, both the ruling and the practitioners fell back on decades of short sale case law supporting identification in the face of fungibility. This ancient case law holds short sales open until the identified shares that are the subject of the short sale are delivered to cover it.[77]

Although Revenue ruling 2003-7 represents something of a retreat from recent attempts to establish common law constructive sale treatment for certain stock hedges, it appears unlikely that the ruling will be the last word on the subject. In view of the rather narrow scope of the section 1259 constructive sale rules and the increasing use and sophistication of derivatives in connection with stock hedges, there will continue to be a significant pressure on the concept of "tax ownership" in relation to publicly traded securities.

The Meaning of "Disposition" in Canada

Case Law on "Disposition"

In Canada, some case law suggests that in certain circumstances a hedging transaction may constitute a "disposition" of the underlying securities for tax purposes. The courts have on many occasions signalled that the concept of "disposition" and "proceeds of disposition" should be given the broadest possible meaning.[78] For example, Ewens and Flatters have written:

> To appreciate the breadth of the concept of a disposition of property in the Act, one need look no further than the decision of the Federal Court—Trial Division in *Olympia & York Developments Ltd. v. The Queen*. In that case, the taxpayer agreed to sell an apartment complex but retained title to the building pending the payment of

76 Trier and Farr, supra note 29, at 516; and Schizer, supra note 16, at note 98.

77 Sheppard, supra note 47, at 651-52.

78 For a discussion of these cases, see, for example, Ewens and Flatters, supra note 63, at 1386 et seq.

the balance of the purchase price, which was not due until an agreed-upon future time. Under the terms of the agreement, however, the taxpayer completely divested itself of all the duties, responsibilities, and charges of ownership together with all the profits, benefits, and incidents of ownership, except legal title. Upon examining the civil law of Quebec relating to real property, the court concluded that even though the transfer of all the benefits and charges of ownership to a purchaser in possession amounted to something "equivalent" to a sale, it still did not constitute a sale at law.

Notwithstanding this finding, however, the court proceeded to determine that in the circumstances of the case there was a "disposition" of the complex within the meaning of former section 20 of the Act (now section 13). . . . It concluded as follows:

> Section 20(5)(c) states that "disposition" includes sale and several other types of payment such as compensation for damage, amounts payable under a policy of insurance, etc., but does not purport to be exhaustive of the definition of "disposition" contained in section 20(5)(b) which I have quoted. In fact, section 20(5)(b) itself, which uses the word "includes," is not itself an exhaustive or restrictive definition. In this respect, in delivering judgement on behalf of the Supreme Court of Canada, Pratte, J. in *Her Majesty the Queen v. Compagnie Immobilière BCN Limitée* [1979] 1 SCR 865 stated at page 876:
>
> > The substantive definitions of "dispositions of property" and "proceeds of disposition" in s. 20(5)(b) and (c) are a clear indication that the words "disposed of" should be given their broadest possible meaning.[79]

The *Olympia and York* case and similar decisions[80] are interesting in a monetization context because they suggest that where an investor divests herself of all or substantially all of the incidents of ownership of securities through a monetization strategy, she may be found to have "disposed" of the securities for the purposes of subsection 248(1) of the Income Tax Act, and to have received "proceeds of disposition" for the purposes of section 54 of the Act, notwithstanding the fact that she continues to hold title to the securities that have been monetized. On this reasoning, it appears open to a court to conclude that the following strategies result in a "disposition" of the securities that are the subject of the strategies:

---

79 Ibid., at 1390.

80 *Olympia and York Developments Ltd. v. The Queen*, [1980] CTC 265 (FCTD). See, for example, *Construction Bérou Inc. v. The Queen*, [2000] 2 CTC 174 (FCA) (trucks were "acquired" pursuant to paragraph 13(21)(b) of the Act as taxpayer had acquired beneficial ownership of trucks by assuming possession, use, and risk); *Robert Bédard Auto Ltée v. MNR*, [1985] 2 CTC 2354 (TCC) (despite reservation of ownership, the lessee had possession and use and assumed the risks inherent in the property leased; accordingly, there was a "disposition" for tax purposes, even though there had not been a sale at law); and *MNR v. Wardean Drilling Ltd.*, [1969] CTC 265 (Ex. Ct.) ("a purchaser has acquired assets . . . when title has passed . . . or when the purchaser has all the incidents of title, such as possession, use and risk, although legal title may remain in the vendor as security for the purchase price as is the commercial practice under conditional sales agreements").

- a forward sale of a fixed number of securities, or
- a collar with embedded strike prices that are closely correlated to the value of the security as of the date of the transaction (for example, a share with an FMV of $100 is hedged by means of a collar with embedded strike prices of $98 (put) and $102 (call)).

In the two examples above, the investor has divested herself of the key incidents of ownership: opportunity for profit and risk of loss. As noted earlier, it should make little difference whether the forward contract or the collar is accompanied by an upfront payment of cash or whether the upfront payment is from the same party as the counterparty on the forward sale or the collar.[81]

Although *Olympia and York* and similar cases suggest that a disposition of property may occur when there is a transfer of all or substantially all of the incidents of ownership of the property, there are a number of weaknesses to this argument in the context of a stock hedging transaction. These are considered next.

Absence of a Legal Connection to the Securities Monetized

The first argument likely to be asserted against the characterization of a monetization as a disposition of appreciated securities is that there can be no disposition of securities if there has been no actual dealing in the securities. In the *Olympia and York* decision, the taxpayer was deemed to have disposed of the real property (land and three buildings) in question, notwithstanding its retention of title, because the purchaser received possession, the opportunity for gain, and the risk of loss in respect of the property. In the case of a monetization strategy involving securities, although the strategy may have the effect of transferring the principal incidents of ownership—opportunity for profit and risk of loss—to a third party, arguably there is no formal legal connection to the securities that are monetized. Although a monetization arrangement may involve a pledge of appreciated securities, the taxpayer typically retains the right to substitute at the time of settlement identical securities or the cash equivalent. Of course, it makes little difference in economic terms whether a taxpayer ultimately settles a monetization transaction by delivery of the pledged securities, delivery of identical securities acquired in the market (or swapped for the securities that were originally pledged),

81 Although an upfront payment superficially heightens the transaction's resemblance to a sale, the timing of the payment should be irrelevant to the consideration of whether there has been a disposition and whether realization treatment continues to be appropriate. Accordingly, it should make no difference whether the put is accompanied by a loan, prepayment, or other upfront payment of funds. See, for example, Trier and Farr, supra note 29, at 519: "[T]he difference between an upfront payment with respect to a derivative and a payment made at maturity with respect to an otherwise identical derivative reflects principally the time value of money, and not the operation of the derivative or the underlying asset, suggesting that this timing differential should not be relevant to the constructive sale analysis."

or cash (realized through a sale of the securities that were originally pledged). Arguably, however, unless the taxpayer is compelled in some manner to deliver specifically the appreciated securities, it cannot conclusively be said that the taxpayer has transferred the incidents of ownership of *these specific securities*. As Tom Clearwater has noted, this absence of a direct legal connection to the securities that are monetized represents a significant challenge to the argument that there has been a disposition of such securities:

> [A] derivative replicates economic incidents of owning a given type of property without creating a legal connection to that property. Because derivatives peg contractual obligations to property value fluctuations through abstract means, they are inexpensive to implement, are portable, and may be transposed, either singly or in combination, to a variety of financial circumstances to produce made-to-design financial effects. They can be similarly employed to produce made-to-design tax effects, and here lies their rub: specifically, derivatives can be used to render certain otherwise non-elective elements of the tax system—including realization timing and, in some cases, characterization—elective in effect. Viewed from this angle, derivatives represent a considerable challenge to present methods of measuring and taxing income.[82]

The Plain Meaning of "Disposition"

The second argument likely to be asserted is that the courts are constrained by the use of the terms "disposition" and "proceeds of disposition" in the relevant provisions in the Act. Even with the direction that the words "disposed of" are to be given "their broadest possible meaning," the courts are still required to give these terms an interpretation that they can reasonably bear. It is arguably not permissible to interpret "disposition" as, for example, "any event the occurrence of which suspends the policy rationale for realization treatment." Such an interpretation would mean that the *acquisition* of a separate security or financial instrument, such as a put, would constitute a *disposition* of a different security, or an interest in that security. This arguably goes well beyond any possible interpretation of the word "disposition." In effect, the court would be ignoring the plain meaning of the words in the Act and reading in words that, in the view of the court, Parliament should have used.

The Retention of Some Exposure

A third argument for the potential inapplicability of the *Olympia and York* line of cases is that, in these cases, there was a transfer of all or substantially all of the incidents of ownership. In many monetization transactions, the taxpayer retains some exposure to price movement in the underlying stock. In the acquisition of a put, for example, there has been divestment of only one incident of ownership—the risk of loss. In the case of a collar, there may only be a partial divestment of risk

82 See Clearwater, supra note 69, at 1216.

of loss and opportunity for gain. To argue that there has been a "disposition," therefore, it may be necessary not only to fragment ownership into separate incidents, but also to fragment individual incidents of ownership. Again, this seems to strain at the boundaries of a reasonable interpretation of "disposition." The investor still holds many of the ordinary incidents of ownership—opportunity for further appreciation; risk of loss in respect of amounts over and above the strike price (that is, to the extent that there is further appreciation in value, the risk of loss of that further appreciation); the right to receive dividends; the right to vote; and so on. It seems unlikely that a court will conclude that the transfer of a risk of loss alone is sufficient to constitute a "disposition" of the security, on the grounds that ownership of a security entails much more than just one attribute of ownership. Consequently, if an investor simply acquires a put option and thereby divests herself of the risk that the security will fall in value below the put option strike price, it is difficult to assert that she has disposed of the underlying security. This appears to be the position in both Canada and the United States.

A Security as a Bundle of Rights

One response to this argument is to say that a security does not represent a single, indivisible thing. In economic terms, a security represents a "bundle of rights" or a collection of economic elements. Because derivatives can be used "to fragment ownership, giving different taxpayers different rights to the various economic elements that together are generally associated with property ownership,"[83] an all-or-nothing approach that restricts the concept of "disposition" to transactions that involve a divestment of *all* of the incidents of ownership makes little sense.

One alternative to treating a security as a single, indivisible thing is to treat it as a bundle of rights and to recognize separate dispositions of discrete rights.[84] In the case of an investor who holds stock with an acquisition cost of $10 and a fair market value of $100, the acquisition of a put with a strike price of $100 locks in the accrued but unrealized $90 gain. In a sense, the investor has converted the opportunity or potential for appreciation between $10 and $100 into a certain gain of $90. The investor continues to enjoy the opportunity or potential for appreciation over and above $100. The potential for appreciation between $10 and $100 has been exchanged for a fixed claim. In converting the portion of the gain from contingent to fixed, the rationale for realization treatment vis-à-vis this gain falls away. There is no longer a case for the permitted income deferral that realization treatment ordinarily presumes.

83 Faber, Kramer, and Pomierski, supra note 23, at 770.

84 Note that the definition of "disposition" in section 248(1) appears to contemplate separate dispositions of discrete interests in a security. See, for example, subparagraph (b)(i) in the definition of "disposition," which refers to "a share, bond, debenture, note, certificate, mortgage, agreement of sale or similar property, or an interest in it."

One criticism of this approach is that it appears to raise difficult valuation issues, in terms of both the cost base of the right disposed of and the market value of the bundle of rights remaining. However, these difficulties are not insurmountable. A practical solution is to allow the investor to elect a cost base of any amount up to the acquisition cost for the share. If all or substantially all of the value of the share as a whole is represented by the existing appreciation in the value of the share (that is, there is little potential for additional appreciation, and the remaining rights have little value), then a cost base of $10 for the appreciation right does not seem inappropriate. If there is significant value in the share aside from the appreciation that has occurred (that is, the potential for continued appreciation is significant, there is a dividend entitlement, or the voting rights have value), then allowing the investor to attribute the entire acquisition cost of $10 to the one right disposed of—the opportunity to participate in gain between $10 and $100—is, arguably, unduly generous to the investor. As a practical solution, however, the limited income deferral here seems far preferable to the much greater income deferral that arises when the share is treated as a single, indivisible thing.

It may be argued that an approach that treats a share as a bundle of rights is administratively complex; but monetization transactions are themselves necessarily complex and necessarily dependent on professional advice. Monetization strategies seek to fragment ownership into separate rights and deal with such rights in different ways. A judicial response that seeks to determine tax consequences on a similar basis does not seem unwarranted.

As noted in this section, if a taxpayer chooses to monetize rather than sell appreciated securities the securities, he may be expected to argue that the monetization does not represent a "disposition" of such securities. It seems likely that these arguments will find acceptance in the courts. The manner in which the US tax authorities have responded to monetization transactions—namely, the adoption of the constructive sale provisions in section 1259 of the US Internal Revenue Code—arguably implies a recognition that the courts are unable or would be unwilling to consider related financial positions in determining the tax consequences of transactions that affect an appreciated financial position. The US constructive sale provisions are considered next.

THE US RESPONSE TO EQUITY MONETIZATION

Introduction

The Internal Revenue Code contains two sets of provisions that have particular relevance to monetization transactions: the "straddle" rules in section 1092 and the "constructive sale" rules in section 1259. Congress introduced the straddle rules in 1981 in response to a number of perceived abusive transactions the principal purpose of which was tax avoidance.[85] Similarly, the enactment of the constructive

85 New York State Bar Association Tax Section, "Comments on Proposed 'Straddle' Legislation" (2000) vol. 87, no. 6 *Tax Notes* 823-46, at 825. See also Schizer, supra note 16, at notes 116 and 180.

sale provisions as part of the TRA was in direct response to a number of avoidance transactions that attracted considerable media attention—in particular, Estée Lauder's "short sale against the box" transaction in 1995 (discussed above), which is believed to have allowed Estée Lauder to defer (and possibly avoid altogether) more than $100 million in tax.[86] This article focuses on the constructive sale rules as they are specifically targeted at certain monetization strategies. Although the straddle rules also potentially have application to monetization strategies, they were primarily designed to address abusive transactions involving commodities. There is considerable uncertainty about the extent to which the rules apply to securities.[87]

The 1996 Constructive Sale Proposals

In January 1996, the Clinton administration submitted proposals to Congress that were specifically targeted at certain monetization strategies that were considered abusive, including the widely publicized "short sale against the box" strategy employed by the Lauder family.[88] In the original proposals, if a person owning an "appreciated financial position" entered into one or more transactions that substantially eliminated both the opportunity for gain and the risk of loss with respect to the position, the person would be deemed to have made a constructive sale of the position.

As a result of industry lobbying[89] and perceived congressional opposition to a rule that potentially represented a significant departure from the realization principle,[90] the proposals were adopted in narrower form in 1997 as part of the broader taxpayer relief amendments. In the form adopted, the rule is restricted to specific, identified hedging transactions that closely resemble sales. According to the legislative history of the provision, these transactions were targeted because they "have the effect of eliminating substantially all of the taxpayer's risk of loss and opportunity for income or gain with respect to the appreciated financial position."[91] Section 1259 is briefly considered next.

---

86 Stone, supra note 22.

87 The extent to which the straddle rules apply to monetization transactions remains somewhat uncertain. The New York State Bar in its commentary (supra note 85, at 825) in respect of the proposed new straddle rules notes that "many, if not most of the unanswered questions that arise with respect to the straddle rules pertain to straddles involving stock and related positions. . . . Application of these rules to the many types of stock-related hedging transactions common in today's markets can entail significant uncertainties."

88 For more information on the history of these proposals, see Faber, Kramer, and Pomierski, supra note 23, at 782. See also David A. Weisbach, "Should a Short Sale Against the Box Be a Realization Event?" (1997) vol. 50, no. 3 *National Tax Journal* 495-506.

89 See Lee Sheppard, "Rethinking DECS, and New Ways To Carve Out Debt" (1999) vol. 83, no. 3 *Tax Notes* 347-52, at 349.

90 See Schizer, supra note 16, at 1344 et seq.

91 United States, Staff of the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997*, 105th Cong., 1st sess., JCS-23-97 (Washington, DC: US Government Printing Office, 1997), 177; discussed in Schizer, supra note 16, at note 104.

Constructive Sales Treatment for Appreciated Financial Positions

Code section 1259(a)(1) provides that where there is a "constructive sale" of an "appreciated financial position," the taxpayer is required to recognize a gain as if the position had been sold, assigned, or terminated at its FMV on the date of the constructive sale. The term "position"[92] means "an interest, including a futures or forward contract, short sale, or option." An "appreciated financial position" generally means "any position with respect to any stock, debt instrument, or partnership interest if there would be gain were such position sold, assigned or otherwise terminated at its fair market value."[93]

A constructive sale is defined in Code section 1259(c) as follows:

> For purposes of this section—
>
> (1) In general [a] taxpayer shall be treated as having made a constructive sale of an appreciated financial position if the taxpayer (or a related person)—
>
> (A) enters into a short sale of the same or substantially identical property,
>
> (B) enters into an offsetting notional principal[94] contract with respect to the same or substantially identical property,
>
> (C) enters into a futures or forward contract to deliver the same or substantially identical property,
>
> (D) in the case of an appreciated financial position that is a short sale or a contract described in subparagraph (B) or (C) with respect to any property, acquires the same or substantially identical property, or
>
> (E) to the extent prescribed by the Secretary in regulations, enters into 1 or more other transactions (or acquires 1 or more positions) that have substantially the same effect as a transaction described in any of the preceding subparagraphs.

There is an exception to the constructive sale rule for certain sales of non-publicly traded property in section 1259(c)(2), and for certain short-term hedges in section 1259(c)(3), which reads as follows:

> (A) In general
>
> In applying this section, there shall be disregarded any transaction (which would otherwise be treated as a constructive sale) during the taxable year if—
>
> (i) such transaction is closed before the end of the 30th day after the close of such taxable year,

92 Code section 1259(a)(3).

93 Code section 1259(b)(1). Code section 1259(b)(2) provides for certain exceptions for classic debt, certain hedges based on classic debt, and any position that is marked to market.

94 This is defined in Code section 1259(d)(2) as an agreement that includes

> (A) a requirement to pay (or provide credit for) all or substantially all of the investment yield (including appreciation) on such property for a specified period, and
>
> (B) a right to be reimbursed for (or receive credit for) all or substantially all of any decline in the value of such property.

> (ii) the taxpayer holds the appreciated financial position through the 60-day period beginning on the date such transaction is closed, and
> (iii) at no time during such 60-day period is the taxpayer's risk of loss with respect to such position reduced by reason of a circumstance which would be described in section 246(c)(4) if references to stock included references to position.

Accordingly, short-term hedges which are closed out within 30 days of the end of the taxation year in which the transaction takes place are excluded if the taxpayer bears the risk of loss with respect to the appreciated financial position for at least 60 days following the close of the transaction.

The Impact on Monetization Activity in the United States

The constructive sale rules have reportedly been successful in closing down a number of specifically targeted planning strategies, such as the "short sale against the box" strategy. However, as is perhaps inevitable in the case of narrow reforms targeted at specific transactions, it appears that investors have been able to sidestep the restrictions through minor adjustments to the monetization transactions. As David Schizer notes, the "use of derivatives in effect to sell appreciated assets without paying tax remains pervasive."[95]

In many respects, Code section 1259 is a disappointing response to the challenges posed by monetization transactions. By its terms, Code section 1259 is quite narrow in scope. Under the original Clinton administration proposals, a constructive sale would have occurred whenever a taxpayer (or a related person) executed a transaction that, when considered in conjunction with a related long position, eliminated (with respect to the long position) substantially all of the risk of loss and opportunity for gain.[96] In the form finally enacted, however, Code section 1259 delineates a number of specific forms of trades, and it delegates to the IRS the authority to delineate additional forms of trades that have substantially the same effect. It is likely that the "shopping list" approach ultimately adopted leaves inventive tax advisers a fair degree of room to develop alternative strategies that achieve a similar effect.[97]

First, as long as an investor who monetizes his or her position retains some degree of market exposure, the investor will probably not be caught by the constructive sale rules:

> The typical way to avoid section 1259, understood by the government and taxpayer alike, is to retain some exposure to the hedged asset's return—in other words, to use a partial hedge. For example, if an asset is worth $100, the taxpayer can accept risk of

95 Schizer, supra note 16, at 1339.

96 Willens, supra note 23, at 198.

97 David Schizer notes that taxpayers in many cases are able to substitute insurance contracts and other forms of contracts for derivative contracts to achieve similar tax-planning objectives. See Schizer, supra note 16, at 1319 and 1335.

loss from $100 to $95 (by buying a put at $95), while retaining opportunity for gain from $100 to $115 (by selling a call at $115). This combination of owning a put and selling a call is known as a "collar." Other derivatives, such as swaps and forward contracts, can offer the same result.[98]

The constructive sale rules do not specifically address the question of collars, and it remains an open question when a collar will be so "tight" as to constitute a constructive sale. The House and Senate reports that preceded the enactment of TRA 1997 discussed, without blessing or condemning it, a collar with a put strike price of $95 and a call strike price of $110. It was proposed that the question of when a collar will constitute a constructive sale be dealt with in the regulations. To date, no regulations have been promulgated. Harmon describes the present situation with respect to collars as follows:

> Absent regulations, practitioners have focused on a number of factors to determine whether the collar is "reasonable." These factors include (1) the stock's volatility, (2) absolute difference in strikes, i.e., the collar spread, (3) the length of time of the collar transaction, and (4) the extent to which the investor retains the right to and risk of changes in the amount of dividends. None of these factors alone is critical. Under the current state of the law, an investor can derive comfort that a collar is reasonable if a review of all of these factors indicates that an investor has not surrendered "substantially all" of the benefits and burdens of the underlying stock.
>
> Notwithstanding this facts and circumstances approach, the prevailing school of thought is that the major focus should be on the period of time and the spread. As a practical matter, investors have become comfortable that a collar is not abusive if it is: (1) a short term collar (one to two years) with at least a 10% spread; (2) a 5 year or less term collar with a 15% spread, and (3) a longer term collar with a spread of at least 20%.[99]

Second, the constructive sale rules should have no application to "one-sided" option strategies. As Willens noted, "The purchase of a put option to protect against declines in the price of long stock bears no resemblance to the constructive sale paradigm Congress has selected because the holder of a put participates, without limit, in price appreciation."[100]

A further disappointing feature of the 1997 amendments is that, with the exception of certain provisions that seek to deny a basis step-up in the case of transactions where the constructive sale occurred prior to the enactment of the constructive sale rules, but the decedent dies after that date,[101] there is no attempt to tax appreciated gains at death. In contrast to the situation under the Income Tax Act,[102] it

98 Ibid., at 1345-46.

99 Harmon and Breen, supra note 71, at 835 (footnotes omitted).

100 Willens, supra note 23, at 199-200.

101 Willens (ibid., at 200) characterizes this as a "thinly veiled attempt to penalize Estée Lauder herself."

102 Paragraph 70(5)(a) of the Act.

remains the case that there is currently[103] no deemed disposition and reacquisition at death. This anomaly represents an estimated annual revenue loss in excess of $25 billion.[104] As long as the opportunity permanently to avoid the taxation of gains through this step-up in basis on death continues, monetization strategies will continue to be enormously attractive.

THE CANADIAN RESPONSE TO EQUITY MONETIZATION

Introduction

There is currently no Canadian counterpart to the constructive sale rules in Code section 1259. Indeed, the treatment of derivative instruments under the Act has been characterized as one of general neglect.[105] Aside from certain limited measures aimed at options and certain hybrid securities,[106] there are generally no rules to prevent taxpayers from extracting accrued but unrealized gains through the use of derivatives.

Although the Income Tax Act generally does not address the question of derivative-based financial products, the fact that such products are the foundation of many sophisticated and creative strategies to minimize tax raises the question of whether any of the anti-avoidance provisions in the Act have application. Foremost of these is the GAAR.[107]

---

103 As noted earlier, the status of Code section 1014 (the rule that provides for basis step-up on death) is somewhat uncertain at present: see supra note 25.

104 Lawrence Zelenak, "Taxing Gains at Death" (1993) vol. 46, no. 2 *Vanderbilt Law Review* 361-441.

105 Edgar, supra note 15, at 53.

106 See generally J. Scott Wilkie, "Looking Forward into the Past: Financial Innovation and the Basic Limits of Income Taxation" (1995) vol. 43, no. 5 *Canadian Tax Journal* 1144-66, at 1150.

107 Section 245 of the Act reads as follows:

> (1) In this section, "tax benefit" means a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act; "tax consequences" to a person means the amount of income, taxable income, or taxable income earned in Canada of, tax or other amount payable by or refundable to the person under this Act, or any other amount that is relevant for the purposes of computing this amount; "transaction" includes an arrangement or event.
>
> (2) Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.
>
> (3) An avoidance transaction means any transaction
>
> (a) that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit; or
>
> (b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may

The GAAR

The GAAR was introduced in 1988 to replace an earlier version of section 245, which attempted to police perceived abuses associated with the claiming of excessive deductions and thereby "unduly" or "artificially" reducing the taxpayer's income. The present version of section 245 is drafted much more broadly and attempts to minimize opportunities for tax avoidance through ignoring for tax purposes the consequences of "avoidance transactions."

To determine whether the GAAR applies to a transaction, it is first necessary to determine whether the transaction would, but for the application of the GAAR, give rise to a tax benefit. A "tax benefit" is defined in subsection 245(1) as "a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act." If there is a tax benefit, it is then necessary to determine whether the tax benefit is the result of an "avoidance transaction." The definition of "avoidance transaction" in subsection 245(3) reads as follows:

> An avoidance transaction means any transaction
>
> (a) that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit; or
>
> (b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit.

It is next necessary to determine whether the transaction in question could reasonably be considered to "result directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole." This is as a result of the application of subsection 245(4):

---

reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit.

(4) For greater certainty, subsection (2) does not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole.

(5) Without restricting the generality of subsection (2),

(a) any deduction in computing income, taxable income, taxable income earned in Canada or tax payable or any part thereof may be allowed or disallowed in whole or in part,

(b) any such deduction, any income, loss or other amount or part thereof may be allocated to any person,

(c) the nature of any payment or other amount may be recharacterized, and

(d) the tax effects that would otherwise result from the application of other provisions of this Act may be ignored,

in determining the tax consequences to a person as is reasonable in the circumstances in order to deny a tax benefit that would, but for this section, result, directly or indirectly, from an avoidance transaction.

> For greater certainty, subsection (2) does not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole.

As has been noted elsewhere,[108] there is some tension between these two provisions. In order to conclude that a monetization transaction is an "avoidance transaction," it is necessary to conclude that the monetization transaction should properly come within the definition of "disposition." However, if a court interprets the words "disposition of property" in accordance with ordinary standards of statutory interpretation—that is, reading the words "in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act and the intention of Parliament"—and concludes that a monetization transaction does not come within the definition of "disposition of property," it may fairly be questioned how the court could then find that there has been a misuse or an abuse of the provisions of the Act.

On its face, however, the GAAR appears to pose a significant threat to many monetization transactions. A monetization transaction clearly results in a "tax benefit." It allows a taxpayer to replicate the economic consequences of a sale without triggering the tax consequences of a sale. It allows the taxpayer to replicate a realization event without triggering realization treatment.

Can it be said that the monetization "may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit"? In most cases, it seems unlikely. Investment banks routinely market monetization strategies as a means of unlocking cash from an appreciated equity position without triggering the tax consequences associated with a sale. One practitioner has suggested that the only reason for effecting a short sale against the box is to avoid tax.[109] Where, in any given case, the primary motivation in using such a strategy is not to avoid tax consequences, it will generally be the case that there is another avoidance motivation at work: a desire to avoid some form of regulatory or contractual constraint. In view of the significant transaction costs associated with such strategies, there are few obvious business reasons[110] to prefer a monetization strategy over an outright sale that are untainted by some form of avoidance motivation.

---

108 Warren J.A. Mitchell, "GAAR: A Snapshot," in *Report of Proceedings of the Fifty-Third Tax Conference*, 2001 Conference Report (Toronto: Canadian Tax Foundation, 2002), 2:1-6.

109 See, for example, Weisbach, supra note 88, at 497, citing Kleinbard, supra note 71, at 783-99.

110 One possible non-avoidance motivation might be the case where the voting rights are particularly valuable to an investor. In theory, an investor could finance the acquisition of a control position by acquiring voting securities, selling off the economic interest in the securities, and using the proceeds from such transactions to acquire additional voting securities.

Can it be said that a monetization transaction may reasonably be considered to result, directly or indirectly, in a "misuse of the provisions of [the] Act or an abuse having regard to the provisions of [the] Act . . . read as a whole"? It is a general policy of the Act that appreciation in a capital asset will not be taxed until it is "realized." In my view, monetization cannot reasonably be viewed as anything other than a form of realization. From a tax policy point of view, there is little or no justification for continued realization treatment of the now locked-in (and perhaps extracted) gain. In the example of the taxpayer given above, the gain is no longer "potential or anticipated." There is no risk that, in the words of Lord Reid, "the market may fall, and the profit might never be realized." The appreciation in value from $10 to $100 is now fixed. One cannot seriously argue that the taxpayer is not richer by this amount. It is now available, at any time that the taxpayer chooses, to satisfy the taxpayer's wants and needs. At that time, since the policy rationale for continued income deferral no longer applies to the return that has become fixed, income deferral should cease.

As noted previously, one of the principal obstacles to characterizing a monetization transaction as a disposition of the underlying security is that, in the majority of cases, the monetization transaction does not directly involve the underlying security. It is necessary to conclude that the acquisition of a related financial position leads to the disposition of another financial position. In my view, however, the reference in the definition of "avoidance transaction" to "a series of transactions, which series . . . would result, *directly or indirectly*, in a tax benefit" (my emphasis) is an invitation to consider related financial positions and the effect of such positions on an appreciated financial position.

Although the taxpayer can be expected to argue that intolerable uncertainty will follow if the CCRA is entitled to consider related financial positions, this argument should not be overstated. A taxpayer's intention is generally a question of fact. In most cases, it should not be difficult to discern the taxpayer's true intention. In the simple example of a taxpayer who owns securities with an acquisition cost of $10 and an FMV of $100, it is absurd to suggest that the acquisition of a put entitling the taxpayer to put these securities (or identical securities) to a third party at a price of $100 is anything other than a transaction intended to protect the accrued $90 gain. It is equally absurd to argue that a court must consider each position separately, such that

- there is no realization of the appreciated securities because *these specific securities* have not yet been sold, and
- the value of the put is indeterminate because it has not yet been exercised. At the time of acquisition of the put, the put has only nominal value because the strike price is equivalent to the current FMV of the issuer's securities.

In my view, a court should be entitled to make reasonable inferences as to when financial positions are in fact integrated with other financial positions, and to determine tax consequences on the basis of the integrated transaction as a whole. This point was forcefully made by Lord Wilberforce in the *Ramsay* case:

> While the techniques of tax avoidance progress and are technically improved, the courts are not obliged to stand still. Such immobility must result either in loss of tax, to the prejudice of other taxpayers, or to Parliamentary congestion, or (most likely) to both. *To force the courts to adopt, in relation to closely integrated situations, a step by step, dissecting, approach which the parties themselves may have negated, would be a denial rather than an affirmation of the true judicial process.* [Emphasis added.][111]

As Arnold noted, the House of Lords was able to arrive at this conclusion without the need for a statutory anti-avoidance provision.[112] Rather, the House of Lords has effectively "rejected the *Duke of Westminster* principle that a taxpayer is entitled to minimize tax payable, and it has rejected the proposition that the courts cannot consider the substance of a series of transactions."[113]

Although I believe that the GAAR is potentially applicable, in view of recent jurisprudence, in relation to the appropriate tax treatment of derivative instruments (and in particular the decision of the Supreme Court of Canada in *Shell Canada*),[114] it is doubtful that the courts will be prepared to make use of this tool. The *Shell* decision is considered next.

The Shell Canada Decision

The facts in *Shell Canada* are complex and need not be set out in detail here. Essentially, Shell Canada needed to borrow US $100 million for five years for general corporate purposes. The prevailing interest rate for a direct borrowing by Shell Canada was approximately 9.1 percent. This interest cost would have represented a deductible expense to Shell Canada. Shell Canada investigated whether it might be possible to reduce its financing costs, and Goldman Sachs proposed a strategy employing what is known in tax circles as a Kiwi loan (a loan of New Zealand dollars) and certain hedging transactions. The prevailing market rate for a loan of an equivalent amount in New Zealand dollars was 15.4 percent. Accordingly, there was a higher interest rate cost (and thus a higher annual expense, deductible from income) associated with the New Zealand borrowing, which was then immediately converted into US funds. However, the higher interest rate payable on the borrowing of New Zealand funds was "effectively equalized"[115] by a discounted forward rate for New Zealand currency at the maturity date of the borrowing. In other words, at the time of the initial borrowing it could be determined that, at the maturity date, the principal amount of US$100 million would return a greater number of New Zealand dollars than had been initially borrowed. Shell Canada

111 *W.T. Ramsay Ltd. v. IRC*, [1981] STC 174, at 181-82 (HL). This decision is considered in Arnold, "Reflections," supra note 10, at 26.

112 Arnold, "Reflections," supra note 10, at 28.

113 Ibid., at 26.

114 Supra note 12.

115 *The Queen v. Shell Canada Ltd.*, [1998] 2 CTC 207, at paragraph 49 (FCA).

was able to predict with reasonable certainty, since risks associated with foreign exchange fluctuations had otherwise been hedged, that it would achieve a gain on the capital account that would effectively equal the increased expense on the income account.[116]

The addition of the Kiwi loans and the hedging structure was a pure arbitrage play. The trial judge found as a fact that Shell Canada had no use for the New Zealand funds other than as part of the overall structure, and that Shell Canada's overriding purpose in entering into the various transactions was to secure US$100 million at the lowest possible after-tax cost.[117] The aggregate effect of the various transactions was (1) to increase an interest expense on a borrowing from 9.1 percent to 15.4 percent, and (2) to generate a capital gain at the term of the loan corresponding to the increased interest cost. The advantages of this structure principally result from (1) the fact that Shell Canada had certain capital losses that it could not offset against income but only against capital gains, and (2) the fact that capital gains were taxable at a discounted rate.

The Federal Court of Appeal upheld the minister's appeal from the Tax Court and refused to allow the deductibility of the interest over the 9.1 percent that had been established to be the prevailing US market rate. The court was prepared to accept that the gain on the foreign currency exchange was properly on the capital account. What is noteworthy about Linden JA's decision is his willingness to accept the minister's invitation to look beyond the legal form of discrete steps in the transaction and attempt to determine the economic substance of the transaction as a whole. Linden JA concluded that

> [t]here is no doubt that Shell has achieved a "patina of compliance" in arranging its financing as it did. However, form does not always trump substance. It is possible to strike a balance between the two. In this case, Shell has achieved the substance of a US$ borrowing in the form of a NZ$ debenture. If the tax system is going to avoid the iniquities spoken of by Dickson C.J.C. [in *Bronfman Trust*], where a taxpayer's sophistication and financial resources determine the extent of his or her tax liability, then the taxpayer who, in substance, borrows US$, should be taxed on that basis.[118]

On June 14, 1999, at the conclusion of the hearing on the matter, the Supreme Court allowed the appeal of the taxpayer and dismissed the minister's cross-appeal. In delivering the judgment of the court, McLachlin J recognized that the sequence of steps in the overall transaction "allowed [Shell] to earn a foreign exchange gain

---

116 Linden JA noted (ibid., at paragraph 49): "The evidence heard at trial and accepted in the literature is that, in reality, there is no discrepancy between interest rates for convertible currencies. This is so because interest rate parity theory dictates that the differential between the forward and spot exchange rates of two currencies equals the differential between the interest rates of those two currencies."

117 Ibid., at paragraph 6.

118 Ibid., at paragraph 64.

and, when the transactions were considered together, to equalize the interest rate in the Debenture Agreements to the prevailing market rate for a loan of US$."[119] However, McLachlin J expressly refused to permit a recharacterization of the transaction along the lines of its economic substance or to be drawn into an examination of the economic realities of the transaction; she noted that each of the steps in the overall transaction was legally effective and that the form of the transaction should be respected:

> Both the Minister and the Federal Court of Appeal seem to suggest that s. 20(1)(c)(i) [the provision allowing for the deduction of interest] invites a wide examination of what Linden J.A. referred to (at para. 44) as the "economic realities" of the taxpayer's situation. Underlying this argument appears to be the view that taxpayers are somehow disentitled from relying on s. 20(1)(c)(i) if the structure of the transaction was determined by a desire to minimize the amount of tax payable.
>
> This Court has repeatedly held that courts must be sensitive to the economic realities of a particular transaction, rather than being bound to what at first appears to be its legal form. . . . But there are at least two *caveats* to this rule. First, this Court has never held that the economic realities of a situation can be used to recharacterize a taxpayer's *bona fide* legal relationships. To the contrary, we have held that, absent a specific finding that they are a sham, the taxpayer's legal relationships must be respected in tax cases. Recharacterization is only permissible if the label attached by the taxpayer to the particular transaction does not properly reflect its actual legal effect. . . .
>
> Second, it is well established in this Court's tax jurisprudence that a searching inquiry for either the "economic realities" of a particular transaction or the general object and spirit of the provision at issue can never supplant a court's duty to apply an unambiguous provision of the Act to a taxpayer's transaction. Where the provision at issue is clear and unambiguous, its terms must simply be applied.[120]

In view of the Supreme Court's recent tax jurisprudence, this is not a surprising result. However, this approach to interpreting tax legislation appears virtually to negate any application for the former version of section 245 (which was in effect at the time the Shell Canada transaction was entered into):

> In computing income for the purposes of this Act, no deduction may be made in respect of a disbursement or expense made or incurred in respect of a transaction or operation that, *if allowed, would unduly or artificially reduce* the income. [Emphasis added.]

The Supreme Court appears to be saying that if a transaction is legally effective and is not otherwise a sham (such that the legal form of the transaction does not accurately reflect the parties' actual legal position), then the court must respect the legal form of the transaction without regard to the underlying economic purpose, even if the primary economic purpose of the transaction is clearly to reduce the tax

119 Supra note 12, at paragraph 42.

120 Ibid., at paragraphs 38-40.

that would otherwise be payable. Here, it was not disputed that the addition of a step whereby Shell Canada borrowed in New Zealand funds and then converted such funds into US dollars was solely to reduce income tax otherwise payable. The trial judge found that Shell Canada's "overriding purpose" in entering the forward and hedging arrangements was to secure funds in US dollars at the lowest after-tax cost attainable.[121] However, the Supreme Court attached significance to the fact that, with respect to the debentures pursuant to which Shell Canada was able to borrow the initial New Zealand funds, the lenders were at arm's length with Shell, and the debentures imposed a legally binding obligation to pay interest at the prevailing rate of 15.4 percent.

This approach appears to leave no room for the application of section 245 except in sham transactions. But in the case of sham transactions, the court does not need to rely on section 245. When a court finds as a fact that a transaction's legal form misrepresents the parties' actual legal position, the court will determine the tax consequences on the basis of the parties' actual legal position. Section 245, one would have thought, directs a court to examine the economic reality of a transaction to determine (1) the tax that would have been payable had the form reflected the economic reality (here, a direct borrowing of US funds), and (2) whether the legal form of the transaction (here, the addition of a step whereby Shell first borrowed New Zealand dollars and then converted the funds into US dollars) "artificially" or "unduly" reduces the tax that would have been payable under point 1. In keeping with a fairly consistent line of jurisprudence through the 1990s, the Supreme Court declined to engage in this inquiry.

When the Supreme Court released its decision in *Shell Canada* in October 1999, there was some question whether the decision might have limited implications for precedent in view of the fact that the language of section 245 had since been replaced with the much more substantial (and ominous-sounding) GAAR. However, early signs are that the direction taken by the Supreme Court in the *Shell Canada* case will carry over to cases under the new section 245.

The Canadian Pacific Decision

Canadian Pacific Ltd. was allowed to appear as an intervenor in the *Shell Canada* case on the grounds that Canadian Pacific had been reassessed by the minister on a virtually identical structure involving Australian dollars. Once *Shell Canada* was decided, the sole issue to be resolved in the *Canadian Pacific* case was the application of GAAR to the facts of that case. The GAAR did not apply to the facts of *Shell Canada* because it was not yet in force. Following the decision of the Supreme Court in *Shell Canada*, the appeal by Canadian Pacific was remitted to the Tax Court of Canada for legal and factual determinations regarding the case and the present language of section 245. Bonner TCJ delivered his reasons for judgment in October 2000.[122]

---

121 Supra note 115, at paragraph 6, per Linden JA.

122 *Canadian Pacific Ltd. v. The Queen*, [2001] 1 CTC 2190 (TCC).

In this case, Canadian Pacific required Canadian dollars but sought to lower its overall borrowing costs, when viewed on a purely economic basis, by adding the step of first borrowing in Australian funds and then exchanging the funds for Canadian dollars. Bonner TCJ concluded that it was "clear that a direct borrowing of C$ could have been accomplished at an interest rate far lower than 16.125%,"[123] the rate applicable to the Australian borrowing. Bonner TCJ was

> not persuaded that the A$ borrowing offered the Appellant any significant non-tax advantage which would have been unavailable had the Appellant chosen to borrow C$ directly. The A$ borrowing therefore reduced tax by generating interest costs deductible under paragraph 20(1)(c) which were substantially higher than C$ borrowing costs and by reaping offsetting advantages in a form which, in light of the decision in Shell Canada Ltd., I am compelled to regard as a capital gain. Clearly, the transaction resulted in a tax benefit.[124]

Although Bonner TCJ found that a clear tax benefit resulted from the interposition of a borrowing in Australian funds, he declined to find that the step, or the transaction as a whole, constituted an "avoidance transaction" for the purposes of subsection 245(3) of the Act. The series of transactions challenged by the minister were "inextricably linked as elements of a process primarily intended to produce the borrowed capital which the Applicant required for business purposes."[125] McLachlin J had held in *Shell* that Shell's deduction of its interest payments at the actual rate paid to its lenders, in exchange for funds that were then used for the purpose of producing income, was not contrary to the object and spirit of subparagraph 20(1)(c)(i) of the Act. On the basis of this decision, Bonner TCJ was compelled to find that the present transactions could not be considered an "avoidance transaction." Therefore, section 245 could have no application.

In November 2001, the Federal Court of Appeal heard an appeal on two issues:[126]

- whether the primary purpose for arranging to issue the debentures in Australian dollars was other than to obtain a tax benefit, and
- whether the deduction of the excess interest resulted, directly or indirectly, in an abuse having regard to the provisions of the Act as a whole.

In a unanimous judgment, Sexton JA adopted the approach of Rothstein JA for the majority in *OSFC Holdings Ltd. v. The Queen* and cited the caution Rothstein JA had expressed in that case: "[I]t is important to note that there is no general rule against structuring transactions in a tax effective manner or a requirement that a

123 Ibid., at paragraph 12.

124 Ibid.

125 Ibid., at paragraph 15.

126 [2002] 2 CTC 197 (FCA).

transaction be structured in a manner that maximizes tax."[127] Sexton JA held that it was not possible "to separate the currency of the borrowed funds from the borrowing itself so as to make the denomination of the borrowing a discrete transaction in and of itself."[128] The extended definition of "transaction" in section 245 could "not be interpreted to justify taking apart a transaction in order to isolate its business and tax purposes."[129]

> The words of the Act require consideration of a transaction in its entirety and it is not open to the Crown artificially to split off various aspects of it in order to create an avoidance transaction. In the present case, the Australian dollar borrowing was one complete transaction and cannot be separated into two transactions by labeling the designation in Australian dollars as a separate transaction.[130]

Sexton JA stated,

> I do not believe that it is possible to separate the currency of the borrowed funds from the borrowing itself so as to make the denomination of the borrowing a discrete transaction in and of itself. It is the very borrowing that is the transaction, not the denomination of the currency. The foreign currency is the very thing that CP borrowed under the debentures and without those Australian dollars the lenders could not have provided CP with the money that is the subject matter of the contract.[131]

There is a certain element of conclusionary reasoning in this statement. If the various transactions (a borrowing in Australian dollars, a swap involving the exchange of Australian dollars for Japanese yen, and a swap involving the exchange of Japanese yen for Canadian dollars) are characterized as one transaction—a borrowing in Japanese yen for general business purposes—then arguably the primary purpose of the transaction as a whole is a borrowing for general business purposes. However, one can similarly group virtually any tax-driven transaction with some broader transaction or set of transactions and then conclude that the primary purpose of the transaction taken as a whole was not to obtain a tax benefit. In *Canadian Pacific*, the various transactions involved separate agreements between separate parties over separate periods. Although, as Sexton JA noted, "without those Australian dollars the lenders could not have provided CP with the money that is the subject matter of the contract," there is no evidence that CP was required to borrow from those lenders or that it could not borrow directly in Japanese yen. The additional steps of first borrowing in Australian dollars and then converting

127 [2001] 4 CTC 82, at paragraph 117 (FCA).

128 Supra note 126, at paragraph 23.

129 Ibid., at paragraph 24.

130 Ibid., at paragraph 26.

131 Ibid., at paragraph 23.

the dollars into yen were completely superfluous to the borrowing transaction. Those steps had no purpose other than to produce a tax benefit.

There is a sense of artificiality about the weak currency loans described in *Shell Canada* and *Canadian Pacific*. If the GAAR is not applicable in transactions of this nature, then it is truly questionable whether the courts would be willing to apply the GAAR to a monetization transaction. Indeed, in a recent technical interpretation, the CCRA explicitly cites *Shell Canada* as the basis for its decision that a short sale transaction will not be considered a disposition, for the purposes of the Act, of other shares held by the borrower that are otherwise identical to the borrowed shares:

> The Supreme Court has held, in *Shell Canada v. The Queen*, 99 DTC 5669 (SCC) and other decisions, that the economic realities of a situation cannot be used to recharacterize a taxpayer's bona fide legal relationships. It has held that, absent a specific provision of the Act to the contrary or a finding that there is a sham, the taxpayer's legal relationships must be respected in tax cases.
>
> Thus, it is our view that generally a contract relating to the short sale of securities acquired under the terms of a securities lending agreement and the legal relationships created therein cannot, absent a specific provision of the Act to the contrary, the general anti-avoidance rule or a finding that there is a sham, be recharacterized. As such, a short sale transaction to hedge an individual's position with respect to identical shares held on capital account will not be considered a disposition, for purposes of the Act, of other shares held by the borrower that are otherwise identical to the borrowed shares and which are ultimately used to settle the short position.[132]

Although the statement quoted above appears to leave open the possibility that the CCRA may attempt to recharacterize a transaction under the GAAR on the basis of the Supreme Court's resolution of the *Shell Canada* decision, in my view a court will probably decline to take up this tool. Recent pronouncements from the Supreme Court of Canada[133] suggest that the principles of *Duke of Westminster*[134] are alive and well in Canada today, and that, so long as the parties negotiate a legally effective transaction and the transaction is not at law a "sham," the legal form of the transaction will be respected. The revenue authorities will not be permitted to recharacterize a transaction in accordance with its perceived economic substance rather than its apparent legal form.

---

132 CCRA document no. 2002-0131355, July 3, 2002.

133 This principle was affirmed by McLachlin J (as she then was) in *Hickman Motors Ltd. v. The Queen*, [1998] 1 CTC 213, at paragraph 8 (SCC):

> It is a fundamental principle of tax law that "[e]very man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be": *Inland Revenue Commissioners v. Duke of Westminster*, (1935), [1936] A.C. 1 (H.L.), at p. 19, *per* Lord Tomlin. As Wilson J. put it in *Stubart Investments Ltd. v. R.*, [1984] 1 S.C.R. 536 (S.C.C.) at p. 540, "[a] transaction may be effectual and not in any sense a sham (as in this case) but may have no business purpose other than the tax purpose."

134 *Inland Revenue Commissioners v. Westminster (Duke)*, [1936] AC 1 (HL).

Consequently, I suspect that a court will analyze a typical monetization transaction (for example, a collar and loan transaction) as follows:

- the collar and loan transaction simply represents a form of borrowing against an appreciated asset;
- borrowing against an appreciated asset has never been recognized as a disposition of that asset;
- borrowing against an asset for the purpose of diversification of portfolio risk is a legitimate, ordinary commercial practice;
- to the extent that the borrowing involves a derivative such as a collar, this is simply a risk management tool and is incidental to a legitimate, ordinary commercial practice;
- the minister cannot object merely because the taxpayer has chosen to borrow against an appreciated asset rather than sell the asset; and
- in the absence of express statutory authority, the court has no authority to depart from the plain meaning of terms such as "disposition of property." If Parliament intends to expand these concepts to include hedging transactions, express statutory language is necessary.

It is possible to portray monetization strategies in such a benign light; but this portrayal ignores that fact that monetization strategies are primarily avoidance strategies. Investment banks market monetization strategies principally on the strengths of their avoidance potential. If the GAAR cannot be applied against at least certain forms of monetization, then one must ask whether the courts see any role for a general anti-avoidance rule. What role, if any, do the courts see for themselves in the policing of avoidance transactions? I would argue that in this regard the courts need to consider the consequences of allowing avoidance transactions to flourish, both in terms of tax policy and non-tax policy. This point is considered next.

TAX POLICY CONCERNS

Why Should We Be Concerned About Equity Monetization Transactions?

On the one hand, it can be argued that strategies that exploit tax arbitrage opportunities can lead to new forms of financial innovation, with resulting efficiency gains through more effective risk allocation and risk management. As Edgar has noted,

> [I]nnovation that is driven by tax avoidance tends to expose the weaknesses of existing tax structures and forces consideration of fundamental reform. Thus tax-driven financial innovation can produce social benefits, and may even lead to its own elimination by encouraging the elimination of the differences in taxation that are its sources.[135]

135 Edgar, supra note 15, at 33.

Tax arbitrage strategies may also produce social welfare benefits in that they may help investors diversify their portfolios and avoid the "lock-in effect" associated with the realization principle.[136]

However, it must also be acknowledged that significant social costs are associated with the development and proliferation of monetization strategies. These costs are a consequence not so much of the strategies per se but of the factors (discussed above) that have encouraged such strategies to flourish. These costs are considered below.

Efficiency Costs

There are several aspects to the efficiency costs of monetization strategies in particular and derivative-based avoidance strategies in general. First, there is a cost in terms of the state's ability to raise revenue and the public resources committed in the continual need to amend tax legislation to respond to tax-avoidance schemes. As Arnold has argued,

> The Supreme Court of Canada's reluctance or unwillingness to play any role in policing aggressive tax avoidance clearly results in a loss of tax revenue. . . .
>
> The second point . . . in favour of the courts' playing an active role in controlling tax avoidance is that, otherwise, Parliament must legislate with respect to every new tax-avoidance technique. . . . The difficulty, of course, is that Parliament is always at least one step behind the tax-avoidance industry. Moreover, complaints are frequently heard about the length of time it takes to enact tax amendments. Many necessary technical amendments to the Act simply do not get made because of the limitations of the parliamentary legislative agenda. Unlike the House of Lords, the Supreme Court of Canada does not mention these considerations; it simply says, in effect, "It's not our job to control tax avoidance and the reason is that we've said so many times in the past." There is no justification for the Supreme Court to continue to take such an antiquated approach to its role in the tax system. By doing so, it is largely responsible for the flourishing of tax-avoidance schemes to the detriment of most taxpayers.[137]

Monetization strategies also impose significant efficiency costs on taxpayers. Although a taxpayer who engages in monetization is able to obtain a tax benefit, there is an offsetting loss to the revenue authorities. This must be made up from other taxpayers, by borrowing (in essence, from future taxpayers), or by reduced spending. Assuming that no overall efficiency gains (or losses) are associated with the transfer of an additional dollar from the government's pockets to a private taxpayer's pockets, or from one taxpayer to another, the economic consequences of

136 See, for example, Weisbach, supra note 88, at 499 et seq. In this context, the "lock-in effect" refers to the fact that the realization requirement in the Act may induce investors to hold an asset rather than sell it simply to avoid triggering a tax liability. Taxpayers may not wish to lose the implicit subsidy inherent within the realization rule, with the result that they may have less than perfect portfolio diversification.

137 Arnold, "Reflections," supra note 10, at 26-27.

a monetization strategy appear to be distributional rather than wealth-creative. Of course, the professional advisers who develop and market monetization strategies can earn large fees and commissions for these activities. Although these fees are paid out of the tax savings enjoyed by the taxpayer, they ultimately come at the expense of other taxpayers. The fees are not expended for the purpose of new productive investment. They are simply incurred to arrange a redistribution of wealth from some taxpayers (typically, wage earners) to other taxpayers (typically, high-net-worth taxpayers) and, it may be suggested, they represent a waste of resources—a "dead weight loss" to society.[138]

More generally, there is a cost to all taxpayers in the form of an increasingly unwieldy income tax system. As Parliament is forced to legislate in response to every new tax-avoidance technique, the Act becomes more convoluted and complex, and taxpayers must bear additional costs in attempting to determine their rights and obligations.

Neutrality Concerns

Monetization strategies raise significant neutrality concerns because they distort taxpayer behaviour. To gain access to a tax benefit, taxpayers who normally would otherwise simply sell the securities that make up their holdings have an incentive to enter into costly substitute transactions that replicate, in economic terms, a sale. This alteration of taxpayer behaviour may also have implications for other parties that seek to regulate, monitor, or otherwise constrain the activities of the taxpayer.

Equity Concerns

Monetization strategies would also seem to be offensive to principles of tax fairness in several ways. Arnold's comments on tax-avoidance schemes are equally applicable to monetization strategies:

> The Supreme Court of Canada's reluctance or unwillingness to play any role in policing aggressive tax avoidance clearly results in a loss of tax revenue. The revenue lost must be made up from other taxpayers. These other taxpayers are generally salaried employees and other taxpayers who have little opportunity to engage in tax-avoidance transactions. The benefits of aggressive tax avoidance belong to corporations and wealthy individuals who can afford professional advice. At the beginning of the 21st century, surely it is appropriate to reconsider whether the fundamental principle of our tax system should be that everyone should pay his or her fair share of tax, or the *Duke of Westminster* principle that everyone has the right to arrange his or her affairs to minimize tax.[139]

The fact that our tax system allows for a significant tax deferral when a disposition of an economic interest is structured as a monetization, as opposed to a sale, is

---

138 See, for example, Weisbach, supra note 88, at 499.

139 Arnold, "Reflections," supra note 10, at 26.

unfair to investors (and other holders of capital assets) who cannot afford to pay for professional advice. As the earlier discussion relating to transaction costs made clear, monetization strategies are not for everyone. Among individual shareholders, monetization strategies are, practically speaking, available only to high-net-worth shareholders.[140] The Supreme Court seems to place little weight on fairness in its approach to the interpretation of the Act. In *Shell Canada*, McLachlin J wrote for a unanimous court:

> [T]he Federal Court of Appeal seems to have discerned in the Act an intention that courts, to be fair to less sophisticated taxpayers, should be alert to using complex transactions designed to minimize their tax liability. It was said that courts should somehow look through transactions and impose tax according to their true economic and commercial effects. There are some *obiter* statements in some cases that may be said to support this view. . . .
>
> However, this Court has made it clear in more recent decisions that, absent a specific provision to the contrary, it is not the courts' role to prevent taxpayers from relying on the sophisticated structure of their transactions, arranged in such a way that the particular provisions of the Act are met, on the basis that it would be inequitable to those taxpayers who have not chosen to structure their transactions that way. . . . Unless the Act provides otherwise, a taxpayer is entitled to be taxed based on what it actually did, not based on what it could have done, and certainly not based on what a less sophisticated taxpayer might have done.[141]

More generally, monetization strategies are unfair from a tax equity point of view in that they compound the already highly favourable tax treatment accorded to transactions that are said to be "on the capital account."[142]

---

140 David Schizer notes that in the United States, "individuals with positions worth between $1 million and $75 million . . . have become the core clientele of a thriving hedging industry." See Schizer, supra note 16, at 1347.

141 *Shell*, supra note 12, at paragraphs 44-45.

142 There are two principal advantages to categorizing an economic gain as a "capital gain" rather than "income": (1) currently, only one-half of the economic gain is included in "income," and (2) a taxpayer already has a significant opportunity to defer a tax liability on an accrued gain by deferring a realization of that gain. From an economic perspective, it is difficult to support a distinction between an economic gain in the nature of "income" and an economic gain in the nature of a "capital gain." Under the Haig-Simons concept of income, an accretion to wealth is income regardless of source.

The treatment of a gain on the capital account may be contrasted with the tax treatment applicable to the form of income on which most Canadians depend—employment income. Generally, the full amount of salary or wages (with only very limited scope for deductions) constitutes "income." Moreover, employment income is taxed when it is received. The second advantage, the ability to defer recognition of a gain through a deferral of a realization of that gain, is less valuable in the case of a highly volatile asset, such as public company securities. However, a monetization strategy allows an investor to fully exploit this advantage. The monetization strategy allows the investor to crystallize (or realize) his or her gain without the event's being recognized as a "realization" event for tax purposes.

Overall, then, monetization strategies should be objectionable to other taxpayers for two reasons:

- to the extent that the investor achieves a tax saving, this saving comes at the expense of other taxpayers, who must pay a proportionately higher amount (or face a corresponding reduction in government-funded services); and
- monetization strategies exacerbate the existing tax preference accorded to economic gains that are characterized as capital gains.

Simplicity Concerns

Much of the Income Tax Act's complexity derives from the "the action and reaction endlessly produced by complex, specific tax measures aimed at sophisticated business practices, and the inevitable, professionally-guided and equally specialized taxpayer reaction."[143] The response to equity monetization transactions in the United States is representative of this phenomenon. As we have previously seen, the US revenue authorities have taken a "shopping list" approach to itemizing certain types of transactions that will be treated as constructive sales. In view of the narrow scope of the provisions and the fact that the revenue authorities will always be struggling to play catch-up with innovative and increasingly sophisticated monetization strategies, it seems likely that new strategies have developed, or will develop, to defeat the intent of the constructive sale provisions.

An alternative approach, based on principles rather than long schedules of rules, would provide a route out of this endless cycle of action and reaction. At first blush, the legislative landscape in Canada appears well suited to this approach. The courts have available to them the necessary tools to interpret concepts such as "disposition" or "change in beneficial ownership" in a purposive and contextual manner. In those instances where these statutory interpretation tools are insufficient to check aggressive tax-avoidance strategies, the courts have a formidable tool in the form of the GAAR. However, the courts must actually take up and make use of these tools. Recent decisions of the Supreme Court suggest that our highest court is not prepared to do this, at least in the tax context. Accordingly, if Canadian tax authorities are to respond to the challenges posed by equity monetization strategies, further pages of rules and regulations will have to be added to the Act.

This section examined a number of tax policy concerns posed by equity monetization strategies. The next section examines a number of non-tax policy concerns and questions whether the courts' approach to tax avoidance encourages other forms of avoidance.

NON-TAX POLICY CONSIDERATIONS

As noted at the beginning of this article, monetization strategies, in addition to being highly effective tax-avoidance strategies, may also provide opportunities for the avoidance of obligations in other areas of law.

---

143 *Stubart Investments Ltd. v. The Queen*, [1984] CTC 294, at 317 (SCC).

Securities Law Restrictions

The investor may be subject to restrictions or public notice filing requirements under securities legislation or related regulatory (for example, stock exchange) rules. Such restrictions and notice requirements may include

- insider reporting requirements[144] applicable to "insiders"[145] of an issuer;
- a prohibition on trading while in possession of material undisclosed information about the issuer applicable to insiders and other persons in a "special relationship"[146] with the issuer;
- control block restrictions applicable to "control persons"[147] (and a related notice-filing requirement associated with an exemption[148] from these restrictions);
- "hold period" restrictions generally applicable to persons who have acquired stock on an exempt-distribution basis;[149] and
- escrow requirements[150] applicable to certain officers, directors, promoters, and other "principals" of an issuer following the initial public offering of the issuer.

Corporate Law Restrictions

If the investor is an "insider"[151] under a corporate statute such as the Canada Business Corporations Act, the investor may be subject to

---

144 In Ontario, see generally part XXI (Insider Trading and Self-Dealing) of the Securities Act, RSO 1990, c. S.5, as amended (herein referred to as "the Securities Act").

145 In Ontario, see the definition of "insider" in section 1(1) of the Securities Act.

146 In Ontario, see the definition of "person or company in a special relationship with a reporting issuer" in section 76(5) of the Securities Act. An insider trading prohibition may soon be included in the Criminal Code. On June 12, 2003, Bill C-46, An Act To Amend the Criminal Code (Capital Markets Fraud and Evidence-Gathering), was given first reading. Section 5 contains a proposed new insider trading offence.

147 This term is not defined in the Securities Act but is commonly used to mean a person described in clause (c) of the definition of "distribution" in section 1(1) of the Securities Act—that is, a person who holds "sufficient number of any securities of [an] issuer to affect materially the control of that issuer." This clause provides that any person, company, or combination thereof holding more than 20 percent of the outstanding voting securities shall be presumed to be a control person in the absence of evidence to the contrary.

148 See, for example, section 2.8 of *Multilateral Instrument* 45-102, "Resale of Securities" (available online at http://www.osc.gov.on.ca).

149 In Ontario, see generally Ontario Securities Commission, Rule 45-501, "Exempt Distributions" (available online at http://www.osc.gov.on.ca).

150 See, for example, *National Policy* 46-201, "Escrow for Initial Public Offerings" (available online at http://www.osc.gov.on.ca).

151 See, for example, sections 126 and 131 of the Canada Business Corporations Act, supra note 3 (herein referred to as "CBCA").

- a prohibition on knowingly engaging in a short sale of a security of the corporation;[152]
- a prohibition on knowingly buying a put or selling a call in respect of a security of the corporation;[153]
- potential civil liability to a counterparty on a purchase or sale if the insider purchases or sells a security of the corporation with knowledge of confidential information;[154] and
- potential civil liability to the corporation for any benefit or advantage received if the insider purchases or sells a security of the corporation with knowledge of confidential information.[155]

Contractual Restrictions

The investor may be subject to contractual restrictions that prohibit the investor from selling the securities. Examples of such restrictions include the following:

- *"Lockup" agreements*: when an issuer makes a public offering, the underwriters of the offering frequently require founding shareholders (and others) to enter into lockup agreements to restrict any sale by those shareholders for a prescribed period following the offering.
- *Stock-based compensation arrangements*: an investor may participate in a stock-based compensation arrangement, which requires the investor to take a portion of the investor's compensation in the form of securities in order to better align the investor's interests with the interests of shareholders. The arrangements may contain restrictions on selling these securities.[156]
- *Securities law compliance policies*: insiders and other officers, directors, and employees with access to material undisclosed information about the issuer are frequently subject to extensive trading restrictions (for example, during "blackout periods" preceding or following the public disclosure of the issuer's financial results) and trade disclosure requirements contained in the issuer's compliance policies.

These examples are far from exhaustive; they illustrate the circumstances in which a conventional sale may be unattractive or, indeed, illegal. It is not difficult to conceive of other situations, such as a family law proceeding, in which an investor may wish to covertly exit an ownership position without disclosing that he or she has done so.

152 See, for example, CBCA section 130(1).

153 See, for example, CBCA section 130(2).

154 See, for example, CBCA section 130(4).

155 See, for example, CBCA section 130(5).

156 Weinberg, supra note 7.

Family Law

As discussed above, it has been suggested that the Supreme Court has demonstrated a "benign" attitude to a number of tax-avoidance strategies. Would the court take a similarly benign attitude to sophisticated derivative-based transactions if the intent was not to avoid a tax liability but rather to avoid an obligation, prohibition, or restriction under securities law, corporate law, or family law? Consider the example of John, discussed earlier. Assume that ABC Inc. is a public company listed on the Toronto Stock Exchange. John is a director of ABC Inc. On January 1, 2001, John acquired 10 shares of ABC Inc. at the FMV price of $10 per share. On January 1, 2004, shares of ABC Inc. have an FMV of $100 per share. John is concerned that the shares might fall in value, and wants to convert his shares into cash. Suppose that John monetizes these securities as follows: On January 1, 2004, John enters into a secured loan arrangement with InvestBank under which John agrees to borrow, and InvestBank agrees to lend, an amount equal to 90 percent of the FMV of the ABC Inc. shares, or $900. The loan has a term of 10 years. As security for the loan, John pledges the 10 ABC Inc. shares. Recourse under the loan is limited to the pledged security. (In other words, John may settle his obligations under the loan on a cash settlement basis or by physical delivery of 10 ABC Inc. shares.) Finally, suppose that, by January 1, 2006, the FMV of ABC Inc. shares has fallen to its January 1, 2001 level of $10 per share. John's marriage fails, and John becomes a party to an acrimonious family law proceeding in which he is required to deliver to his spouse a sworn financial statement. The financial statement requires John to state, inter alia, his assets and debts.

Is it open to John to list his 10 shares of ABC Inc. at their current value of $10 per share? If John retains any of the proceeds from the monetization transaction (assuming that he has not spent them), presumably he will be required to include them in his "assets" column. Can he show an offsetting liability in the amount of the $900 "loan"? Arguably, John will be able to swear under oath that

- he is the legal and beneficial owner of the (now much diminished) 10 ABC Inc. securities, notwithstanding the fact that, in economic terms, he cashed out his economic interest in these securities in January 2004; and
- he has a liability to InvestBank in the amount of the "loan" proceeds, or $900.

Similarly, if John had negotiated an OTC contract that effectively entitled him to put the stock to InvestBank at $90 a share, are the shares collectively worth $100 or $900 on January 1, 2006? The answer is that the shares viewed in isolation are worth $100; as a consequence of the OTC contract, however, the shares are effectively worth $900. Although the OTC contract arguably can and should be valued as a separate asset, there may be no obligation to disclose or value the contract because it does not (arguably) constitute a "security" in Ontario.[157] Nor, arguably,

157 Part 11(d) of form 13 of the forms under the Ontario Family Law Rules, O. reg. 114/99, as amended, reads as follows: "Securities: Show the items owned on the valuation date by

is there any obligation to value the shares other than on the basis of "their market value if the items were to be sold on the open market."

If the court (or John's spouse) became aware of the monetization transaction, it seems highly unlikely that the court would simply accept reliance on legal form. It is difficult to imagine, for example, McLachlin J making the following statement in a family law context:

> It is a fundamental principle of tax law [family law] that "[e]very man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts [the amount of child support payable] is less than it otherwise would be". . . .[158]

Similarly, it is difficult to conceive of Iacobucci J making the following statement in a family law context:

> It is well established in the jurisprudence of this Court that no "business purpose" is required for a transaction to be considered valid under the Income Tax Act [Family Law Act], and that a taxpayer [support payer] is entitled to take advantage of the Act even where a transaction is motivated solely by the minimization of tax [child support]. . . .
>
> It was entirely open to the parties to use . . . the "technicalities of revenue law" [the technicalities of family law] to achieve their desired end . . . and nothing in the "object and spirit" of any of the various provisions can serve to displace this result.[159]

Is there something special about income tax law that provides it with its own unique canon of interpretive principles? If not, then presumably it is also open for John, in the family law proceeding described above, to conceal the fact that he has altered the value of his securities through indirect means.

Securities Law

As discussed earlier, monetization transactions are successful in a tax context because the disposition, in economic terms, is not considered a "realization" event for tax purposes. In the example above, there is arguably no "disposition" of legal ownership of the securities for tax purposes, even though there is clearly an economic disposition of many of the ordinary attributes of ownership.

Arguably, a similar analysis could be applied in a securities law context to avoid, for example, the statutory requirement on John (who is an insider by virtue of his

---

category. Include bonds, warrants, options, notes and other securities. Give your best estimate of their market value if the items were to be sold on the open market." For a discussion of whether and when an OTC contract may be a security, see, for example, Jeffrey G. MacIntosh and Christopher C. Nicholls, *Securities Law* (Toronto: Irwin Law, 2002), 51 et seq.

158 *Hickman Motors Ltd.*, supra note 133, at paragraph 8.

159 *Duha Printers (Western) Ltd. v. The Queen*, [1998] 3 CTC 303, at paragraphs 87-88 (SCC).

being a director) to file an insider report[160] in respect of the transaction. Under the Act, the realization event is an event that gives rise to "proceeds of disposition." Under Ontario securities law, one of the triggering events is currently[161] a change in an insider's "direct or indirect beneficial ownership of" securities of the reporting issuer (that is, the public company) in respect of which the insider is an insider.

If an insider sells his securities, he is clearly subject to an insider reporting obligation (unless he is otherwise covered by an exemption from the insider reporting requirement). If, however, the insider enters into a monetization transaction that essentially replicates the economic consequences of a sale, does the insider reporting obligation apply? Does a monetization constitute a change in the insider's "direct or indirect beneficial ownership of" the securities in question? The outcome to this question could well depend on the interpretation of the phrase "direct or indirect beneficial ownership of" a security and on the court's approach to avoidance transactions in a securities law context.[162]

One approach that has been endorsed by the Supreme Court of Canada on numerous occasions, in both a tax context and a non-tax context, is the purposive contextual approach articulated by Driedger:

> Today there is only one principle or approach, namely, the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament.[163]

If this is the correct approach, then there seems to be a strong case that a monetization that closely approximated a sale in economic terms would constitute a change in beneficial ownership. There appears to be nothing in the Securities Act

---

160 The following discussion refers to the insider *reporting* obligation under part XXI (Insider Trading and Self-Dealing) of the Securities Act. This should not be confused with section 76 of the Securities Act, which prohibits trading while in possession of material undisclosed information.

161 The members of the Canadian Securities Administrators have recently published for comment a proposed instrument aimed at ensuring that insiders file insider reports relating to monetization transactions and similar derivative-based transactions: see proposed *Multilateral Instrument* 55-103, "Insider Reporting for Certain Derivative Transactions (Equity Monetization)" (available online at http://www.osc.gov.on.ca). In the interest of transparency, I acknowledge my involvement in the development of this proposed instrument.

162 The following analysis is not exhaustive of the analysis that is necessary to determine the question of whether a reporting obligation exists. It does not address other necessary questions—for example, whether the monetization arrangement comes within the scope of the deeming provision in section 106(2)(b) of the Securities Act. Similarly, it does not address the question of whether section 122(1)(b) of the Act might apply to a situation where an insider files an insider report that discloses beneficial ownership of securities, but does not disclose the existence of a related monetization arrangement. A full analysis of the securities law implications of monetizations is beyond the scope of this article. My intention is only to show that the Supreme Court's approach to statutory interpretation in a tax context may also have implications for the interpretation of other statutes, such as securities legislation.

163 Elmer A. Driedger, *Construction of Statutes*, 2d ed. (Toronto: Butterworths, 1983), 87.

that necessarily restricts the concept of a "change in beneficial ownership" to an outright sale. As noted earlier, some case law suggests that, in a tax context, a transfer of all or substantially all of the incidents of ownership, including opportunity for profit and risk of loss, may represent a change in beneficial ownership for tax purposes, notwithstanding a reservation of title. On this basis, there seems to be a good argument that a monetization transaction that closely approximates a sale—for example, a collar transaction under which the investor retains little or no exposure to risk and return—represents a change in beneficial ownership for securities law purposes.

In fact, it is not even obvious that the concept of a "change in beneficial ownership" must refer to a complete divestment of all of the ordinary incidents of ownership. Under a "bundle of rights" theory of what constitutes a security, arguably the transfer of even a single incident of ownership is sufficient for a change in beneficial ownership. The test merely calls for a "change" in the insider's beneficial ownership. It does not necessarily require that all of the rights be divested in their entirety. If an insider, through contractual means, transfers even a single incident of ownership to a third party, there has arguably been a change in the insider's beneficial ownership of the security. The bundle of rights that the insider holds after the transaction is not the same as the bundle of rights that he or she held before the transaction. In view of the particular relevance of the incidents of risk of loss and opportunity for gain to an insider reporting system, it is far from clear that the purposive approach to interpretation described by Driedger of the term "change in beneficial ownership" cannot bear this more nuanced interpretation. If we consider "the scheme of the Act, the object of the Act, and the intention of Parliament," it seems that there is a strong argument for an expansive interpretation of the concept of changes to beneficial ownership, since the policy rationale of an insider reporting regime—deterring illegal insider trading and increasing market efficiency by providing investors with information on the trading activities of insiders of the issuer, and, by inference, the insiders' views of their issuer's prospects—seems to apply equally to a sale and to a monetization that essentially replicates a sale.

So what would the Supreme Court of Canada say? Although the Supreme Court has endorsed the Driedger approach to statutory interpretation on numerous occasions, some commentators have questioned whether the court is prepared to apply this approach in a tax-avoidance case. If this is true, it raises the question: would the Supreme Court be prepared to apply this approach in a securities-law-avoidance case?

Especially in the present climate, it is difficult to imagine the Supreme Court making the following statement in a securities law case:

> It is well established in the jurisprudence of this Court that no "business purpose" is required for a transaction to be considered valid under the *Income Tax Act* [Securities Act (Ontario)], and that a taxpayer [insider] is entitled to take advantage of the Act even where a transaction is motivated solely by the minimization of tax [a desire to avoid public disclosure of the fact that the insider was "cashing out"]. . . .

> It was entirely open to the parties to use . . . the "technicalities of revenue law" [the technicalities of securities law] to achieve their desired end . . . and nothing in the "object and spirit" of any of the various provisions can serve to displace this result.[164]

However, the Supreme Court's "reluctance or unwillingness to play any role in policing aggressive tax avoidance" leads to one of two conclusions:

- either the Supreme Court continues to view tax law as somehow "different" from other complex statutes, with the result that ordinary principles of statutory interpretation do not apply and a strict construction approach is to be employed; or
- the Supreme Court's approach to statutory interpretation in a tax context is no different from statutory interpretation in the context of other complex statutes, such as securities legislation, with the result that the Supreme Court will also be reluctant or unwilling to play any role in policing aggressive avoidance of securities law obligations.

Neither conclusion is particularly appealing. Although the Act has become extraordinarily complex—in part as a result of the "the action and reaction endlessly produced by complex, specific tax measures aimed at sophisticated business practices, and the inevitable, professionally-guided and equally specialized taxpayer reaction"[165]—it is difficult to argue that the subject matter, income tax law, is *inherently* more complicated than other areas of commercial law, such as corporate law, bankruptcy law, or securities law. It is not clear, then, why special principles of interpretation should be necessary for income tax cases. Moreover, to the extent that the Act operates within the broader realm of commercial law, and is replete with commercial law concepts and principles, it makes no sense to say that special principles of interpretation apply to those parts of commercial law that relate specifically to taxation matters.

However, the alternative conclusion is even more troublesome. The Supreme Court's willingness to tolerate even blatant tax-avoidance schemes raises the serious question whether the court will adopt a similarly passive approach to avoidance cases in other areas of law. If this is the case, it is not unreasonable to expect the following consequences:

- other complex statutes will come to resemble the Act in size, complexity, and incomprehensibility—indeed, many would argue that this is already the case with Canadian securities legislation;

164 *Duha Printers (Western) Ltd.*, supra note 159, at paragraphs 87-88.

165 *Stubart Investments Ltd.*, supra note 143, at 317.

- legislative and regulatory resources will increasingly be taken up by the need to respond to aggressive avoidance strategies; and
- judicial tolerance for avoidance strategies will likely encourage additional avoidance activities.

It does not seem unreasonable to expect that tax-avoidance strategies will flourish in an environment in which there is little or no policing of such activities. To use monetization as an example, a wealth management industry appears to have developed in response to the lucrative opportunities for tax avoidance presented by our income tax system. It seems likely that the development of monetization strategies to exploit tax-avoidance opportunities has led to the development of an industry to exploit other opportunities for regulatory arbitrage.