INCOME TAX TREATMENT OF CREDIT SWAPS IN CANADA:
ENHANCING TAX NEUTRALITY

by

Rinat Begaliyev

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This study examines the issue of tax neutrality of the income tax treatment of credit swaps in Canada in domestic context. It analyzes the applicable tax regime consisting of rules on tax characterization, timing and tax rates through the lenses of symmetry, consistency and certainty approaches. The study argues that the Canadian tax policy focuses on achieving symmetry in income tax treatment, rather than consistency. This is because introducing consistency would contradict the fundamental principles of the Canadian law. The study finds that the current tax regime is only partially neutral because symmetry has not been achieved in respect to credit swaps entered between non-financial organizations. To enhance symmetry, the study proposes to adopt a mandatory mark-to-market basis of taxation of credit swaps for the non-financial organizations. Further, to make income tax treatment more certain, the study proposes that the CRA should issue a non-binding guidance on credit swaps.
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INTRODUCTION

Credit derivatives have been in global financial markets since the beginning of 1990s.¹ The tremendous growth of the credit derivatives market has been determined by their ability to meet the demand of financial institutions, mainly banks, for effective means of hedging and diversifying credit risks and corresponding demands of other market players to low-cost means of taking on credit exposure.² Credit derivatives transfer credit risks from one party to another. In theory, the market works by allowing parties wishing to eliminate this credit risk to transfer it to parties who are willing to accept the risks and are more efficient in handling and bearing such risks.³ Thus, credit derivatives should promote efficient allocation of financial resources on global capital markets that enhance the process of wealth creation in the global economy.⁴

To work properly, among other things, the efficient allocation of the credit risks requires neutral taxation of credit derivatives transactions. Tax neutrality posits that the tax system minimizes the distortions in taxpayers’ decision-making so that taxpayers’ neutral decisions on micro-economic level will promote macroeconomic efficiency.⁵ In respect to derivatives, the degree of domestic tax neutrality is determined by neutrality of tax rules on measuring income over time, which

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³ See e.g. Alan Greenspan’s speech to a Senate Banking Committee in 2003: “What we have found over the years in the marketplace is that derivatives have been an extraordinarily useful vehicle to transfer risk from those who shouldn’t be taking it to those who are willing to and are capable of doing so.” The speech is cited on Greg Brown, “NYT: Greenspan Backed Derivatives,” (October 9, 2008), online at <http://moneynews.newsmag.com/streettalk/greenspan_derivatives/2008/10/09/138873.html>.
⁴ See Testimony of Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, before the Committee on Agriculture, Nutrition and Forestry, United States Senate, on 10 February 2000, cited on “Mr Greenspan Gives a Testimony on Over-the-counter Derivatives,” online <http://www.bis.org/review/r000216a.pdf>.
⁵ Gerhard Kraft & Ronald Krengel, “Economic Analysis of Tax Law – Current and Past Research Investigated from a German Tax Perspective,” Research Paper, Martin Luther University Halle-Wittenberg (October 2003), at 8, online: <http://www.wirtschaftsrecht.uni-halle.de/Heft22.pdf> [Kraft & Krengel].
consists of rules on characterization, timing and rates.\textsuperscript{6} The tax system should not provide tax planning opportunities for the taxpayers or windfalls to the governments.\textsuperscript{7} However, in practice the pure neutrality is hard to achieve and the objective of tax neutrality is to seek the optimal degree of neutrality.\textsuperscript{8}

This study examines domestic tax neutrality of the Canadian income tax treatment of credit swaps, namely credit default swaps and total return swaps.\textsuperscript{9} Credit swaps have been selected as the subject of the study because they are the most important economically in the global and Canadian credit derivative markets.\textsuperscript{10} The study has two steps. In the first, the study purports to make an appraisal of the degree of neutrality of the Canadian income tax treatment through examination of applicable tax rules in the context of the Canadian tax policy on credit swaps. Second, based on the analytical outcome at the first step, the study develops suggestions to enhance the neutrality of the income tax treatment of credit swaps.

The methodology of the study is as follows. Chapter I provides a descriptive background to credit swaps. It defines credit swaps in the broader context of derivatives, explains the structure of global and Canadian credit swap markets, their major participants and the participants’


\textsuperscript{9} The study focuses on domestic tax issues such as tax characterization, timing and tax rate. It does not consider international tax issues.

business objectives for the use of credit swaps. Because the income tax treatment depends on the
economic substance of credit swap transactions, the chapter also reviews the financial economic
substance of credit swaps, including their mechanics, payment profile and final settlement
structure. Chapter II sets out the normative framework to examine and appraise the neutrality of
the Canadian tax treatment of credit swaps. It introduces the concept of tax neutrality and
reviews tax literature on approaches of national tax policies to achieve or enhance tax neutrality.
Chapter III analyzes the current state of the Canadian income tax treatment of credit swaps. It
examines tax characterization and timing rules, and tax rates. The chapter argues that general
principles of the Canadian private and tax law and legal documentation of credit swaps
determine the asymmetric accounting of credit swaps, although the mandatory use of mark-to-
market accounting by financial institutions eliminates the asymmetry in credit swap transactions
entered into by the financial institutions. Chapter IV appraises the Canadian tax treatment
against the theoretical background stated in Chapter II. It finds that the tax treatment is neutral in
respect to credit swaps entered into by financial institutions. However, greater tax neutrality
should be introduced to income tax treatment of credit swaps to which a non-financial
organization is a party. Based on the findings of Chapter IV, Chapter V develops suggestions to
improve the current tax framework. It argues that the enhancement of tax neutrality should
proceed through issuing a CRA administrative guidance on credit swaps and introducing
mandatory use of mark-to-market accounting of credit swaps for corporations. The study
concludes with a summary of the findings.
CHAPTER I: AN OVERVIEW OF CREDIT SWAPS

1 BASIC DESCRIPTION OF CREDIT SWAPS

A. Derivatives

A “derivative” is the collective term to define a class of financial contracts that are derived from the underlying financial instruments or assets. The derivatives have two essential features.\(^{11}\) First, the value of the derivative is derived from the value of the underlying financial instruments or assets such as bonds, loans, equities, currencies, commodities, indices, published rates or combinations of those assets.\(^{12}\) The derivatives which value is derived from the underlying financial instruments are called financial derivatives.\(^{13}\) Second, the derivative is a means of transferring the risks on the underlying financial instruments or assets to the other party wishing to accept such risks.\(^{14}\) The derivatives transfer various types of risks\(^ {15}\) and are generally classified based on the type of the risks being transferred.\(^ {16}\)

For the purpose of this study, the derivatives are considered as “risk-shifting financial contracts”\(^ {17}\) and, therefore, it is presumed that one party to the derivative owns and transfers the risks on the underlying financial instruments or assets. The risk-shifting does not reduce risk in

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12 Derivatives Consulting Group, DCG Glossary, online: <http://www.isda.org/c_and_a/oper_commit-dcg-glossary.html#d>.
14 See the definition of derivatives by the International Swaps and Derivatives Association (ISDA): “A financial instrument that transfers risk from one party to the other. It derives its value from the price or rate of some other underlying assets such as bonds, loans, equities, currencies, commodities, indices, published rates or combinations of those assets.” Derivatives Consulting Group, DCG Glossary, online: <http://www.isda.org/c_and_a/oper_commit-dcg-glossary.html#d>; Mengle, *supra* note 2 at 1.
15 The derivatives may transfer currency equity, credit, interest rate, commodity, and other risks. See Wood, *supra* note 11 at 198.
17 Plambeck et al., *supra* note 7 at 658.
aggregate. One party’s gains are matched by the other party’s equivalent losses. Hence, derivatives are zero-sum games and they do not add value.  

B. Credit Derivatives

A “credit derivative” is a financial derivative that is explicitly designed to transfer credit risk between the contracting parties. A credit derivative is a bilateral financial contract that distinguishes credit risk from other risks on the underlying credit instruments (e.g. interest rate or foreign exchange risks), unbundles and transfers the credit risk to the other party. Credit instruments are the instruments by which a lender advances funds (“the principal”) to a borrower for a defined term in consideration of “a promise to repay the funds and a return in the form of the interest that compensates the lender for the forbearance of current consumption implied by the [credit instrument].” They include a bond, a loan, a note and some other credit instruments.

The value of the credit derivative is derived from the value of the underlying credit instruments. The value at any point in time depends on the market’s perception of the credit performance of the borrower under the underlying credit instrument (the “reference entity”) or change in the credit quality of the underlying credit instrument itself due to market risks. Credit risk refers to the risk that the value of the underlying credit instrument will diminish because of a reduction in the reference entity’s capacity to make payments of interest and

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18 Gammie, supra note 6 at 233.
19 Ibid.
20 Mengle, supra note 2 at 1.
24 Ibid. See also Mengle, supra note 2 at 3.
Credit default risk, a type of the credit risk, refers to the significant reduction in the reference entity’s repayment capacity so that the reference entity delays or fails to make scheduled payments.\(^{26}\)

In credit derivatives the parties have asymmetric status in respect to the underlying credit instrument. The buyer,\(^{27}\) a transferor of the credit risk, is a lender under the underlying credit instrument. However, the seller,\(^{28}\) a recipient of the credit risk, is almost always not a party to the underlying credit instrument.

Apart from the credit risk, the buyer has two major concerns: the counterparty credit risk and the expected post-default value of the underlying credit instrument. The seller itself may become insolvent prior to the insolvency of the reference entity and the buyer faces a risk of raising of the protection costs to replace the initial protection. The greater risk for the buyer is a contemporaneous default of the reference entity and the seller. Hence, it is in the buyer’s interest to ensure the lowest possible default correlation between the reference entity and the seller.\(^{29}\)

The post-default value determines the expected recovery rate. Generally, the lower the post-default value of the underlying credit instrument, the higher the cost of purchasing the credit protection.\(^{30}\)

\(^{25}\) PWC, Guide, supra note 21 at 1.

\(^{26}\) Ibid.

\(^{27}\) The term “buyer” refers to both a protection buyer under a credit default swap and a total return payer under a total return swap when the study refers to both types credit swaps.

\(^{28}\) The term “seller” refers to both a protection seller under a credit default swap and a total return receiver under a total return swap when the study refers to both types credit swaps.

\(^{29}\) Antulio N. Bomfim, Understanding Credit Derivatives and Related Instruments (San Diego, CA, USA: Elseveir Academic Press, 2005) at 10, 11 [Bomfim].

\(^{30}\) Ibid. at 11.
C. Credit Swaps

A credit swap is a type of a credit derivative where one party transfers the credit risk on the underlying credit instrument to the other through the exchange of one stream of cash flows against another stream. The streams are calculated over a notional principal amount (i.e., the nominal or face amount of the underlying credit instruments). The notional principal amount does not exceed the par value of the underlying credit instrument. The credit swap establishes the rules of calculation of cash flows and the dates when the cash flows are to be paid.

Credit swaps are unfunded single-name credit derivatives. They are “unfunded” because the seller makes no upfront payment to the buyer to cover its potential future liabilities. Hence, the seller receives the economic return or suffers the economic losses from changes in value of the underlying credit instruments without having to pay out the notional amount. Further, the credit swaps provide protection to the buyer against default by a single reference entity rather than a number of reference entities.

2 CREDIT SWAPS MARKET: AN OVERVIEW

Credit derivatives are traded on the OTC markets. As a result, the credit derivatives transactions are confidential and are not subject to extensive government and exchange

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31 Derivatives Consulting Group defines a notional amount as “the amount of principal underlying the derivative contract, to which interest rates are applied in order to calculate periodic payment obligations.” See Derivatives Consulting Group, DCG Glossary, online: <http://www.isda.org/c_and_u/oper_commit-dcg-glossary.html#d.>
32 Edmund Parker, “Credit Derivatives,” at 4 online: <http://www.mayerbrown.com/london/article.asp?id=4234&nid=1575> [Parker]. On the contrary, a funded credit derivative is a credit derivative embedded in a credit instrument so that a seller makes some upfront payments to a buyer.
33 Bomfim, supra note 29 at 6. Multi-name credit derivatives provide protection against default by a number of reference entities.
34 Anson, supra note 16 at 57.
35 Kolb, supra note 13 at 615.
The markets also have two developmental limitations. First, the liquidity of the market is limited. Second, the counterparty risk is higher than in the case of exchange transactions as the counterparty’s performance of the contracts is not guaranteed (‘counterparty risk’). Hence, the credit derivatives transactions are more risky than exchange transactions so that each party should be certain about creditworthiness of its counterparty. Since assessment of the financial credibility entails additional costs, the market is limited to financially sound corporations and financial institutions. Indeed, individuals do not make any transactions in the credit derivatives market.

Credit derivatives have taken a significant share of the global capital market at an exponential rate. The global market for credit derivatives in terms of the notional amounts outstanding has grown from $180 billion in 1996 to $38.6 trillion dollars in 2008. Among credit derivatives, credit swaps are the most utilized type of credit derivatives. They have taken the greatest, although declining, share of the credit derivatives market: 57 percent in 1996 and 39 percent in 2006. In Canada, as of September 2008, the Big Six Canadian banks had the notional amount outstanding of credit default swaps of about $832 billion.

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36 Ibid.
40 PWC, Guide, supra note 21 at 5.
41 2006 BBA Report, cited in Mengle, supra note 2 at 8.
42 See supra note 10 and the accompanying text.
The financial economics of the credit derivative market has determined the dominance of financial institutions in the market. The market players can be classified as either end-users (the end-buyers and the end-sellers of the protection) or intermediaries. The first group mainly consists of financial institutions (93% of the market): banks and securities firms (59% of the market), hedge funds (28% of the market); and insurance companies (6% of the market). The financial institutions are also major end-sellers (93%): banks (44%), hedge funds (32%) and insurance companies (17%). The investment banks and securities firms perform intermediary functions in the market. Their major role is to provide liquidity to the market.

Non-financial corporations generally do not enter into credit swaps with each other. Their counterparties are mostly financial institutions acting as either end-users or financial intermediaries.

3 ECONOMIC SUBSTANCE OF CREDIT SWAPS

A Credit Default Swaps

A credit default swap (CDS) is a bilateral financial contract by which the buyer (“protection buyer”) transfers to the seller (“protection seller”) credit risk under the underlying credit instrument.

43 See e.g. breakdown of market participants compiled in 2006 BBA Report. Among 165 reporting transactions, non-financial organizations acted as protection buyers to only 2 transactions and as protection sellers to only 1 transaction. 2006 BBA Report, cited in Mengle, supra note 2 at 9. Neither of non-financial organizations was among 20 largest CDS counterparties for 2003-2006, according to Fitch Ratings. Cited cited in Mengle, supra note 2 at 10.
45 Ibid.
46 Anson, supra note 16 at 5.
47 Ibid.
The protection buyer pays to the protection seller a non-contingent fixed premium for the assumed credit default risk. The premium is quoted in basis points per annum of CDS’ notional value. The premium consists of either a single upfront payment in case of a short-term transaction or periodic quarterly or semi-annual payments in case of long-term transactions until the maturity of CDS or occurrence of a credit event.

The CDS term vary from 1 to 10 years depending on the liquidity concerns, with the 5-year maturity being the most common. The maturity of CDS may not coincide with the maturity of the underlying credit instrument. Most CDS’ notional amounts fall between $10 million to $20 million.

The protection seller’s payment obligations to the protection buyer arise if a credit event predetermined in the CDS happens. If a credit event happens, the protection seller is required to pay to the protection buyer a contingent settlement payment. If, however, a credit event does not happen, the protection seller is not obliged to make any payments to the protection buyer.

The protection seller may make a default contingent payment in either of three forms: physical, cash settled form or binary settlement (pre-determined sum). In the former case, the protection buyer delivers the underlying credit instrument to the protection seller and the protection seller repays the par value to the protection buyer. Physical settlement was standard until 2005 but since that it has been replaced by cash settlement. Under cash settlement option, the contingent

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49 A basis point is a unit that is equal to 1/100th of 1% of the notional amount.
51 Nomura, Primer, supra note 50 at 3; Morgan, Guide, supra note 21 (unnumbered).
52 Morgan, Guide, supra note 21 (unnumbered).
53 Nomura, Primer, supra note 50 at 3.
54 Morgan, Guide, supra note 21(unnumbered).
55 Mengle, supra note 2 at 4.
payment mirrors the loss incurred by the protection buyer.\textsuperscript{56} The protection seller pays to the protection buyer the difference between par and the default price of the underlying.\textsuperscript{57} The default price is determined by a dealer poll at some pre-designated time after the occurrence of a credit event,\textsuperscript{58} usually within 14-30 days after the credit event.\textsuperscript{59} The purpose of the time lag is to let the value of CDS to stabilize.\textsuperscript{60} However, in 2008 the market practice turns to an auction method of determining the default price of the underlying credit instrument.\textsuperscript{61} In the case of binary settlement, the parties fix the amount of the contingent payment when they enter into the CDS.\textsuperscript{62}

\textbf{B Total Return Swaps}

A total return swap (“TRS”) is a bilateral financial contract by which a buyer (“total return payer”) exchanges an economic return from the underlying credit instrument for the interest payment by a seller (“total return receiver”). The typical underlying credit instruments are traded bonds and loans.\textsuperscript{63} TRS replicate making a 100 percent leveraged investment in the underlying credit instrument.\textsuperscript{64} TRS allow the total return receiver to derive the economic benefit of owning the underlying

\textsuperscript{56} Morgan, Guide, supra note 21(unnumbered).
\textsuperscript{58} Morgan, Guide, supra note 21 (unnumbered).
\textsuperscript{59} Lehmann Brothers, Guide, supra note 50 at 26.
\textsuperscript{60} Ibid.
\textsuperscript{62} Morgan, Guide, supra note 21 (unnumbered); PWC, Guide, supra note 21 at 15-16.
\textsuperscript{63} Satyajit Das, “Credit Derivatives: CDOs and Structured Credit Products” 3rd ed. (Singapore: John Wiley & Sons (Asia) Pte Ltd., 2005) at 8.
\textsuperscript{64} Joint Committee on Taxation, “Present Law and Analysis Relating to the Tax Treatment of Derivatives (JCX-21-08),” March 4, 2008, at 9, online: <http://www.jct.gov/x-21-08.pdf> [Joint Committee on Taxation].
credit instrument without putting it on its balance sheet. This is called “renting the balance sheet” from the total return payer to the total return receiver.\textsuperscript{65}

The TRS payments are determined by changes in the market valuation of the underlying credit instrument.\textsuperscript{66} As such, the total return payer transfers not only credit risk, but also market risk.

The economic return paid by the total return payer includes interest, fees and any appreciation in value of the underlying credit instrument.\textsuperscript{67} In return, the total return receiver pays to the total return payer a floating or specified fixed or predetermined interest rate, plus any capital depreciation of the underlying.\textsuperscript{68} The total return receiver make payments periodically with reference to the notional amount of the underlying credit instrument and based on objective financial information beyond the control of the parties. The parties make mutual payments in regular intervals, usually quarterly or semi-annually until the maturity.\textsuperscript{69}

The most common maturity of TRS is a period from one to three years.\textsuperscript{70} TRS does not need to match the maturity of the underlying credit instrument and in practice does rarely.\textsuperscript{71}

At maturity or at credit default, the parties evaluate the value of TRS. If the TRS termination value exceeds its initial value, the total return payer pays to the total return receiver the appreciation of TRS. If, however, the termination value of TRS is less than the initial value, the total return receiver pays to the total return payer the depreciation of TRS. The appreciation or depreciation of TRS is determined on the basis of a poll of reference dealers.\textsuperscript{72}

\begin{itemize}
\item \textsuperscript{65} Mengle, supra note 2 at 6.
\item \textsuperscript{66} Morgan, Guide, supra note 21 (unnumbered).
\item \textsuperscript{67} PWC, Guide, supra note 21 at 6.
\item \textsuperscript{68} Ibid. at 8, 9.
\item \textsuperscript{69} Morgan, Guide, supra note 21 (unnumbered).
\item \textsuperscript{70} PWC, Guide, supra note 21 at 6.
\item \textsuperscript{71} Morgan, Guide, supra note 21 (unnumbered).
\item \textsuperscript{72} Morgan, Guide, supra note 21 (unnumbered).
\end{itemize}
In case of a credit default, the parties stop to perform their obligations at the end of the period in which the default occurred.

4 USE OF CREDIT SWAPS

There are two fundamental needs and motivations for use of derivatives: (i) to earn money, and (ii) to manage risks. Correspondingly, there are two basic types of derivatives activity: speculation and hedging. The speculators use credit swaps to earn profits through betting on a default of the reference credit or on future changes in derivatives market. The speculators make bets at lower costs than they would have had they speculated on fundamental goods. Arbitrage, a type of speculation, means seeking opportunities to lock in a profit through taking offsetting positions in two or more credit derivatives. Hedging has been defined as “[a] trading strategy which is designed to reduce or mitigate risk.” The hedgers mitigate the risks of potential unfavourable market exposure through entering into the second transaction to offset the risk of the first.

Based on the assumption that the taxpayer behave rationally and economic substance of credit swaps, it is argued that the only use of credit swaps by the buyers is to hedge their credit risks on

73 "The fundamental need and motivation for both financial institution and client to enter into derivatives transactions is either to earn income (by selling or using a derivative) or to manage a risk.” Hudson, supra note 11 at 7.
74 Margaret Grottenthaler & Phillip J. Henderson, eds., The Law of Financial Derivatives in Canada, (Toronto: Carswell, 1999) at 11-4 [Grottenthaler & Henderson]. Hudson defines four uses: asset liability management, arbitrage, speculation and hedging. However, the first two forms of derivative activity falls into “speculation” use. Hudson, supra note 11 at 4.
76 Hull, supra note 75 at 11. Arbitrage is carried out through two credit swap transactions and tax consequences of each credit swap transaction are similar to that of a speculative credit swap.
77 Derivatives Consulting Group, DCG Glossary, online: <http://www.isda.org/>.
78 Hull, supra note 75 at 10. Derivatives Consulting Group defines “hedging” as follows: “a trading strategy which is designed to reduce or mitigate risk. A second transaction is entered into to offset the risk of the first.” See Derivatives Consulting Group, DCG Glossary, online: <http://www.isda.org/>.
the underlying credit instruments. On the contrary, the sellers enter into credit swaps only for speculative purposes.

The economic position of the buyer as a creditor under the underlying credit instrument and a credit risk transferor under the credit swap presumes that the buyer uses credit swaps exclusively to hedge its risk exposure under the underlying credit instrument rather than to earn profit. The analysis of economic structure of credit swap and the buyer’s economic returns provides only for compensatory character of returns from the credit swap. Indeed, the buyer may not earn any profit from the credit swaps since its receipts may not exceed the funds advanced under the underlying credit instruments. For example, under CDS, the contingent settlement payments to be received by the buyer in case of a credit event could not exceed the par value of the underlying credit instrument. The buyer may receive from the seller only the difference between a par value and a default value of the underlying credit instrument under a cash settlement or a par value in case of physical delivery settlement. Further, under TRS, any excess of the receipts of the buyer over its payments to the seller is highly likely to be offset by the appreciation of the market value of the underlying credit instrument to be paid out by the buyer to the seller. The buyer’s economic return from the seller’s receipts should also be discounted to reflect the time-value of money losses by the buyer due to the prior advancing of the principal amount of the underlying credit instrument to the borrower. Finally, if the buyer purchases a risky credit instrument (a bond or a note) at a high discount, the instrument’s expected post-default value will entail the higher cost for the buyer to purchase the credit swap protection. So, again, the buyer will not receive any profit.

On the contrary, the seller is not able to use credit swaps for hedging purposes; it can use credit swaps only for speculative purposes. Technically, the seller cannot transfer the credit risk to the
buyer on the underlying credit instrument. This is because the seller is not a party to the underlying credit instrument and has no credit risk exposure to it. Furthermore, the structure of credit swaps provides for transfer of the credit risk by the buyer to the seller and not vice versa. Finally, in theory, the seller would also not be able to hedge its credit risk exposure on its other transactions as the seller cannot hedge its risk on the other transactions by assuming additional risks.

CHAPTER II: TAX NEUTRALITY: A CONCEPTUAL FRAMEWORK

1. THE CONCEPT OF TAX NEUTRALITY

The primary goal of a good tax system is to raise revenue for government spending efficiently, fairly, and with the least distortion to the economy.\textsuperscript{79} The taxpayers should make their decisions based on economic reasons without any regard to tax considerations, unless there are market failures.\textsuperscript{80} The key factor in achieving this goal is "tax neutrality." Tax neutrality posits that the tax system minimizes the distortions in allocating resources among competing uses.\textsuperscript{81} Scarce economic resources should be allocated to the most effective uses with the highest underlying rate of return and without any regard to tax considerations.\textsuperscript{82} As Gummie aptly notes “whenever someone would choose to finance one particular asset or activity rather than another based on the pre-tax rate of return offered by the two alternatives, that person should make the same decision based on the post-tax rate of return on those investments.”\textsuperscript{83}


\textsuperscript{80} Kraft & Krengel, \textit{supra} note 5 at 8.

\textsuperscript{81} Gammie, \textit{supra} note 6 at 234.

\textsuperscript{82} \textit{Ibid.}

\textsuperscript{83} \textit{Ibid.}
Achieving neutrality of income tax treatment of credit derivatives presumes that the government should not seek any gains from the taxation of credit derivatives, but should prevent tax planning opportunities. Credit derivative is a zero-sum gain so that the government earns no net gain because its gains from one party are offset by equivalent losses caused by the other party.84 The government participates in the winner’s profit by collecting taxes from it.85 Likewise, it also shares the loser’s losses by allowing a tax deduction.86 However, the parties’ to credit derivative may produce gains through tax arbitrage, when the gain “to be derived from government by a reduction in tax liabilities.”87

In respect to derivatives, the difficulty in achieving domestic tax neutrality is “a function of the difficulties of measuring income over time, in particular where the outcome depends upon specific contingencies.”88 The government regulates measurement of income over time through tax rules on characterization, timing and rates applicable to derivative transactions. Character rules determine whether gains or losses from a derivative transaction are capital or ordinary. The distinct tax treatment between ordinary income (or expenses) and capital gains (or tosses) provides the taxpayers with the tax character options. Capital gains are preferred to ordinary income because only half of capital gains are taxed while ordinary income is taxed in full.89 On the contrary, ordinary losses are preferred to capital losses because only half of capital losses are deductible and they may be offset only against taxable capital gains.90 Hence, the tax minimizing strategies will be to realize losses as ordinary tosses and realize gains as capital gains. Tax characterization determines effective tax rates. The taxpayers take effective tax rates into

84 Ibid. at 233.
85 Schizer, supra note 79 at 1894.
86 Ibid.
87 Gammie, supra note 6 at 233.
88 Ibid. at 234.
89 Paragraph 38(a).
90 Paragraph 38 (b).
consideration at tax planning. Timing rules establish the timing of recognition of capital gains (or losses) and ordinary income (or expenses). The importance of timing is based on the time value of money concept. Taxpayers prefer to accelerate deductions and defer recognition of income in order to lower the present time value of taxes payable. With respect to the tax timing issue, given that capital gains (or losses) are taxed only when realized, tax planning involves deferring the realization of capital gains indefinitely to avoid paying taxes thereon, but realizing capital losses to offset any capital gains unavoidably realized. The ability to implement such a strategy conveys to taxpayers a valuable tax-timing option that can provide them with tax planning incentives.

Tax literature suggests that the government should implement tax neutrality of income tax treatment of derivatives by promoting either of symmetry, consistency or balance of applicable tax rules. Furthermore, regardless the approach taken, tax rules should be certain and simple to understand and apply. Otherwise, even tax neutral rules may entail non-neutral results if the taxpayers misunderstand and misapply them.

A. Symmetry

The symmetry approach requires the national governments to maintain symmetry across two dimensions: (i) tax treatment of the underlying credit instrument and the derivative hedging it,91 and (ii) tax treatment of both sides of the derivative transaction.92 The former requires that the underlying credit instrument and the derivative hedging it should be treated symmetrically, i.e. the character, rate and timing of the derivative shall match the character, rate and timing of the

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91 Plambeck et al., supra note 7 at 658.
92 Schizer, supra note 79 at 1893.
underlying.\textsuperscript{93} If the treatment is not symmetrical, taxpayers will have tax arbitrage options and the hedge will become ineffective on an after-tax basis.\textsuperscript{94}

The latter requires that both parties of a derivative transaction have the same characterization and timing rules and tax rates so that tax consequences for the parties are “equal and opposite.”\textsuperscript{95} In other words, if one party has a deduction another party should have an “equal and simultaneous inclusion.”\textsuperscript{96} Hence, as a result, symmetry gives competing incentives to the parties as tax advantage to one party is matched to tax disadvantage to the other party.\textsuperscript{97} Such competing incentives ensure that the tax system police itself.\textsuperscript{98}

According to Schizer, symmetry is hard to attain in practice and, in reality, it is not a constraint on tax planning.\textsuperscript{99} In domestic context, tax-exempt organizations and financial institutions may accommodate the tax planning of their counterparties. For example, the financial organizations marking derivatives to market would be indifferent to the clients’ characterization and timing of deductions and would not prevent them from acceleration the losses by earlier termination of derivatives.\textsuperscript{100}

\textbf{B. Consistency}

The consistency approach requires that the tax policy makers should aim at accomplishing of equal treatment of economically similar transactions for a certain period. As Jeff Strnad aptly notes:

\begin{footnotesize}
\begin{itemize}
\item[93] Plambeck \textit{et. al.}, \textit{supra} note 7 at 658, 660.
\item[94] \textit{Ibid.} at 660.
\item[96] \textit{Ibid.} at 743.
\item[97] \textit{Ibid.}
\item[98] Schizer, \textit{supra} note 79 at 1894.
\item[99] Schizer makes this statement in respect to the US tax system. \textit{Ibid.}
\item[100] \textit{Ibid.}
\end{itemize}
\end{footnotesize}
“A tax system is consistent if and only if every cash flow pattern has a unique tax treatment. In such a system, it is not possible to manipulate tax outcomes by repackaging cash flows into different financial vehicles.”

To achieve consistency, the government should focus on the economic content and purpose of a derivative transaction, rather than its legal form. Each group of derivative transactions with similar financial economic substance should be taxed on the same timing and rate rules. Otherwise, inconsistent tax treatment would distort taxpayers’ choices."

Based on the experience of the U.S. tax system with several tax rates and timing options, Schizer points out that consistency is hard to achieve across all types of derivatives.

C. Balance

The balance approach to taxation of derivatives is focused on accomplishing the same treatment of timing and tax character of particular types of derivatives. The balance approach states that the taxpayers facing market uncertainty become indifferent to applicable tax rates provided the economic return of a derivative is risk-based. This is because the taxpayers do not have strong preference for high or low tax rates if they do not know in advance whether they apply the tax rates to losses or gains. Furthermore, the risky bet is easy to scale up to eliminate the taxpayers’ dependence on the tax rate. Schizer argues that scaling up bets on unfunded derivatives is costless or entails additional costs that are lower than the costs of tax planning. Hence, the balance approach should impose a powerful constraint on tax planning.

102 Gammie, supra note 6 at 234.
103 Schizer, supra note 79 at 1907.
To measure whether a balanced tax treatment has been achieved, Schizer has introduced a gain-loss ratio which is a proportion of government’s share of gains (taxes imposed) to government’s share of losses (deductions allowed). If the ratio is equal to one, then the balance is achieved and government’s gains and losses are matched. The tax treatment is considered biased towards the taxpayer if the ratio is less than one. Conversely, the tax treatment is considered biased towards the government if the ratio is more than one. At the balance equilibrium, tax system constraints tax planning in the absence of symmetry and consistency.\textsuperscript{104}

Schizer suggests three ways to achieve a balance: mark-to-market accounting; a “stated-term approach,” and a zero tax rate. Under mark-to-market accounting, the taxpayer’s positions are valued in the beginning and the end of the year, and the difference is taxable gain or deductible loss. As a result, the taxpayers would no longer have a tax characterization and timing options because could not control the characterization and timing of their tax. They would also not be locked in to appreciated derivative positions and would have no tax incentive to sell depreciated positions. Under stated–term approach, both gains and losses would be deferred to the scheduled maturity date of the derivative, even if the derivative is prematurely terminated. Taxpayers would have to choose the maturity in advance and could not benefit from planning timing options. They would not have the options to change tax rates as the applicable tax rate would be that at the scheduled maturity year and not in the termination year. Use of a zero rate would provide no tax on risk-based gains, and no deduction for risk-based losses.

D. Certainty

Tax certainty requires that taxpayers should be able to unambiguously determine their tax liabilities with definite and predictable tax result. Tax certainty has two aspects: subjective and

\textsuperscript{104} \textit{Ibid.} at 1897.
The subjective aspect refers to a person’s subjective understanding of its legal rights and liabilities. In this respect, certainty reduces compliance costs by eliminating taxpayer’s propensity to overcomply and undercomply with tax obligations. Indeed, uncertainty on the taxpayers’ tax obligations may have two opposite effects on the taxpayers’ actual tax compliance. On the one side, uncertain tax rules create opportunities for the taxpayers to violate the law, i.e. undercomply, without being detected and punished. As taxpayers are highly elastic to the risk of detection, the higher the chance that undercompliance is not detected, the lower the taxpayers’ incentives to comply. On the other side, uncertain tax rules also create incentives for risk-neutral or risk-averse taxpayers to overcomply in order to reduce the probability of being punished for their improper understanding of the tax law.

The objective aspect relates to the functional and structural regularity of the tax system. The tax rules should be precise, clearly written and unambiguously regulate tax issues arising from taxpayers’ behaviour. Tax obligations should be simple and easy to understand and apply so that the taxpayers precisely know them and may comply with at low cost.

In respect to financial derivatives, certainty requires that taxpayers should be able to unambiguously determine the transaction being taxed and their tax liabilities with definite and predictable tax result. Certain tax law precisely identifies and values transactions and stipulates how the tax amount is to be determined, how and when the tax is to be paid.

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106 Ibid. at 412.
107 Richard Craswell & John E. Calfee, “Deterrence and Uncertain Legal Standards” (1986) 2 J. L. Econ. & Org. at 279 [Craswell & Calfee].
109 Yong, supra note 105 at 412.
110 Schizer, supra note 79 at 1893; Peter W. Hogg, Joanne E. Magee & Jinyan Li, Principles of Canadian income Tax Law 6th ed. (Toronto: Thomson Carswell, 2007) at 49 [Hogg].
guidance should be timely, understandable and readily available to taxpayers. It has been argued that the effectiveness of taxation of derivatives is unobtainable in the absence of a clear understanding of the applicable tax law.\textsuperscript{111} In particular, certainty could be improved by eliminating difficulties of distinguishing between capital gains and ordinary income.\textsuperscript{112}

Certainty is determined by national tax policies on taxation of derivatives. National governments usually take either of three different approaches to taxation of derivatives. They either enact comprehensive legislation to regulate derivatives, or rely on a mixture of general taxation principles and specific rules (based either on the legislation or on guidance issued by tax authorities) to tax derivatives or rely entirely on general tax principles.\textsuperscript{113} In jurisdictions of the third group, like Canada, uncertain tax treatment of derivatives is more likely to arise as it is less responsive to financial derivatives innovation.\textsuperscript{114} In the lack of specific rules, the enforcement practice of tax agencies and prevailing commercial custom “tend to play a greater role, and there may be divergent views on the correct tax position to adopt.”\textsuperscript{115}

Uncertainty is one of the main tax impediment in facilitating the effectiveness and use of derivatives.\textsuperscript{116} Plambeck \textit{et al.} suggests that in case of a lack of specific guidance on taxation of derivatives, such guidance should be introduced to attain the effectiveness of derivatives on an after-tax basis.\textsuperscript{117}

Legal literature suggests the approach to structuring legal rules to provide greater certainty. It posits that if the activity or instrument to be regulated is simple, not changing unpredictably over

\textsuperscript{111} Plambeck \textit{et al.}, supra note 7 at 660.
\textsuperscript{112} Hogg, supra note 110 at 310.
\textsuperscript{114} KPMG, supra note 113 at 2.
\textsuperscript{115} KPMG, supra note 113 at 2.
\textsuperscript{116} Plambeck \textit{et al.}, supra note 7 at 689.
\textsuperscript{117} Plambeck \textit{et al.}, supra note 7 at 660.
time and does not involve significant economic interests, regulation with rules provides more certainty.\textsuperscript{118} If, however, the activity or instrument to be regulated is complex, changing and involve large economic interests “binding principles backing non-binding rules are more certain … if they are embedded in institutions of regulatory conversation that foster shared sensibilities.”\textsuperscript{119}

\textbf{Chapter III: Income Tax Treatment of Credit Swaps}

1. Introduction

The Canadian federal income taxes are levied under the provisions of the Income Tax Act (“Act”).\textsuperscript{120} Other main sources of tax law are Income Tax Regulations, case law, tax treaties, and other public and private law statutes.\textsuperscript{121} However, no tax legislation or a developed body of case law provides specific guidance with respect to credit derivative instruments in general, or credit swaps in particular.\textsuperscript{122} As a result, the income tax treatment of credit swaps must generally be resolved from the application of the Canadian general tax principles, general statutory provisions and rules regulating different (albeit related) derivatives. CRA’s administrative non-binding interpretation bulletins and advance rulings clarifying its position on other kinds of derivatives are also a useful source to understand the current credit swaps tax regime.\textsuperscript{123}

\begin{flushleft}
\textsuperscript{119} Braithwaite, supra note 118 at 71-75.
\textsuperscript{120} R.S.C. 1985 (5th Supp.), c.1. All statutory references in this study are to the Act, unless otherwise indicated.
\textsuperscript{121} David G. Duff, Benjamin Alarie, Kim Brooks & Lisa Philipps, Canadian Income Tax Law, 2\textsuperscript{nd} ed. (Markham, ON, Canada: LexisNexis Butterworths, 2006) at 137-145 [Duff et al.].
\textsuperscript{123} Duff et al., supra note 121 at 144-145.
\end{flushleft}
The Canadian income tax system establishes income tax liability based on the concept of source of income.\textsuperscript{124} The concept presumes that only income from a productive source is included and only a loss from a source is deductible when computing a taxpayer’s income.\textsuperscript{125} There are four main enumerated sources of income: office, employment, business, and property.\textsuperscript{126} The judicial interpretation of the source concept has been restrictive.\textsuperscript{127}

\section*{2. Analytical Framework for Income Tax Treatment of Credit Swaps}

The study employs a three dimensional analytical framework for studying derivatives developed by internationally recognised leading tax scholars and practitioners.\textsuperscript{128} The income tax treatment is examined along three dimensions: the taxpayers, the transaction being taxed, and the aspects of the taxation being considered (the character and timing of income recognition, and tax rates).\textsuperscript{129}

\subsection*{A. The Taxpayers}

The character of the parties is relevant to determine the tax treatment. The tax treatment varies depending on the tax status of the taxpayers and the degree of integration of credit swaps into business operations of the parties.

\textsuperscript{124} Ibid. at 47.
\textsuperscript{125} Section 3. See Hogg, supra note 110 at 94. The unenumerated items are stipulated by sections 56 to 59.1 and include pension benefits, scholarships.
\textsuperscript{126} Duff \textit{et al.}, supra note 121 at 47. Under the concept of the source of income, a taxpayer should compute income and losses from each source separately and then aggregate them to determine the net income from all sources.
\textsuperscript{127} Hogg, supra note 110 at 89.
\textsuperscript{129} See Chapter II Section 2 of this study for explanations of tax issues related to characterization, timing and rates. Since this study concerns with income tax treatment of credit swaps in domestic context, the forth element – source of income – is not considered.
For tax purposes, the users of credit swaps fall into two main groups of taxpayers: financial institutions and non-financial organizations. The former group comprises of banks, credit unions, insurance corporations, corporations which principal business is lending money to arm’s length persons or purchasing debt obligations issued by arm’s length persons, and investment dealers.  

The latter group consists of corporations, mutual fund corporations, and mutual fund trusts.

B. The Transaction

The income tax treatment of a credit swap depends on whether it is linked to the underlying credit instrument. If the linkage is established, the tax characterization of the credit swap is determined by tax characterization of the underlying credit instrument. Therefore, for the purposes of this study the examination of tax status of both credit swaps and underlying credit instruments is required.

(a) Credit Swaps

Neither the Act nor the Canadian private law provides for a statutory definition of a “credit derivative” or a “credit default swap” or a “total return swap.” Hence, the credit swap transaction should be identified with reference to general concepts of the Canadian private and tax law.

\[^{130}\text{See the definition of a “restricted financial institution” in paragraph 142(2)(a), subparagraphs 142.2(a)(i) & (ii), and the definition of a “financial institution” in subsection 248(1).}\]

\[^{131}\text{Mutual funds are excluded from the definition of financial institutions under paragraph 142.2(1)(c) and subparagraph 142.2(1)(d)(ii).}\]

Classification of a transaction as a credit swap is based on its legal form rather than its commercial substance, subject to the possible application of the general anti-avoidance rule (GAAR). This is because the Canadian tax law follows the form over substance doctrine and the legal substance doctrine. The former provides that the courts should respect the taxpayer’s *bona fide* legal relationships and may not disregard them “absent a specific provision of the Act to the contrary or a finding there is a sham.” Under the latter, the courts may not disregard legal characterization of the taxpayer’s transactions unless “the label attached by the taxpayer to the … transaction does not properly reflect its actual legal effect.” As a result, the courts will recognize a transaction as a credit swap if it possesses the essential private law attributes of a contract and have legal effect of a credit swap transaction. In particular, a transaction in which neither party owns and transfers credit risk, such as bets on the occurrence of a credit event under third parties’ credit arrangement, will be denied a legal effect of a credit swap and therefore will not be recognized as a credit swap transaction. Indeed, the bet transaction does not have a legal effect of shifting the credit risk on the underlying credit instrument; rather it creates speculative risks for both parties. It is submitted that the government’s tax policy towards efficient allocation of credit risks in the economy through risk shifting transactions should differ from tax policy towards pure speculative transactions. In practice, the most credit swap transactions are documented on the basis of the 2002 ISDA Model Agreement.

133 Hogg, *supra* note 110 at 615.
For taxation purposes, credit swaps may be classified on several grounds, depending on a factual background. First, credit swaps are generally regarded as “property.” In economic terms, credit swaps represent the parties’ rights on exchange of payments over the notional amount, or, as the Act defines, “a right of any kind whatever.” Such rights fall into the definition of “property.” Second, credit swaps may be characterized as "inventory" when a taxpayer holds them on a trading account. “Inventory” is defined in the Act very broadly as "a description of property the cost or value of which is relevant in computing a taxpayer's income from a business for a taxation year.” Third, credit swaps held by financial institutions are considered “mark-to-market property.” Under the Act, mark-to-market property includes “tracking property.” Tracking property, in turn, includes credit swaps because credit swaps are recorded at fair market value that is determined primarily by reference to another mark-to-market property. Indeed, the fair market value of credit swaps is determined by reference to the criteria of the underlying credit instruments, which is also mark-to-market property. Such criteria include, for example, market value, revenue, income or cash flow from the underlying credit instruments.

Finally, the Act does not regard credit swaps as “specified debt obligations.” A “specified debt obligation” is defined as the interest held by a taxpayer in a credit instrument. However,

(b) Underlying Credit Instruments

Under the Act, underlying credit instruments are classified across two dimensions. They are primarily “debt obligations.”\footnote{Subsection 248(26).} Indeed, a debtor under the underlying credit instrument is a borrower who “becomes liable to repay [borrowed] money” to a creditor.\footnote{Subsection 248(26).} Consequently, the underlying credit instruments are also “specified debt obligations.” Specified debt obligations include debt obligations that are not “prescribed property.”\footnote{Subsection 248(1).} The term “prescribed property” does not include underlying credit instruments.\footnote{Subsection 248(1).}

The underlying credit instruments comprise of loans, lending assets and prescribed property. The term “loan” is not defined in the Act and it should be given a conventional legal meaning.\footnote{See the discussion on the form over substance doctrine and the legal substance doctrine in Section 2 Subsection B of this Chapter.} A “lending asset” is defined as “a bond, debenture, mortgage, hypothecary claim, note, agreement of sale or any other indebtedness or a prescribed share.”\footnote{Subsection 248(1).} Prescribed property includes (i) a security held by a bank and reported as part of the bank's trading account,\footnote{Subsection 248(26).} and a security reported by a taxpayer as an inventory or any financial arrangement reported by the taxpayer as a loan, provided that the taxpayer is entitled to deduct any costs or any amount in respect of the capital cost to the taxpayer of property.\footnote{Subsection 248(1). The definition of the “lending asset” does not include “a prescribed property,” i.e. a property specifically excluded by the Regulation 6209. Regulations 6209 (b)(i). Regulations 6209 (b)(ii) and (iii).}
The Act establishes special treatment of underlying credit instruments in respect to certain groups of taxpayers. The underlying credit instruments issued by Canadian residents are considered “Canadian securities” for the purposes of calculating taxable capital gains and allowable capital losses. Further, underlying credit instruments are considered mark-to-market property for financial institutions because the financial institutions are required to report them at fair market value.

C. Aspects of the Transaction

(a) Characterization

Characterization of a credit swap as held on income or on capital account is important because it determines tax characterization of the subsequent receipts (or payments) under a credit swap. In the absence of the Canadian statutory rules, the issue is regulated by the applicable case law. If a credit swap is held on income account, the character rules give rise to ordinary income (or deduction); however, if a credit swap is held on capital account - to a capital gain (or loss).

Generally, a credit swap is recorded on income account. The nature of a credit swap as a set of contractual obligations and its speculative character provides for income treatment of credit swaps. Indeed, rights and obligations comprising credit swaps do not constitute capital property which may produce income directly. Rather, credit swaps produce profit or loss by

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152 Subsection 39(6) provides that a "Canadian security" means a security that is a share of a corporation resident in Canada, a unit of a mutual fund trust, or a bond, debenture, bill, note, mortgage, hypothecary claim or similar obligations issued by a Canadian resident.

153 See Section 3855 of the CICA Handbook and the definition of mark-to-market property in subsection 142.2(1).

154 Richardson & Broadhurst, supra note 128 at 124.

155 Salada Foods Ltd. v. Canada, 1974 C.T.C.201 (Fed. T.D.) [Salada]. The case arose from a tax dispute over taxation of the proceeds from the foreign exchange futures contracts sold by Salada. Salada argued that the sale of the futures was linked to the protection of an underlying capital asset and treated the gain as a capital gain. The Federal Court of Canada did not accept Salada’s argument. It found that Salada had acted as a speculator in foreign exchange and ruled that Salada should report the gain on income account.
reference to the fluctuating values of underlying credit instruments on their sale or maturity.\textsuperscript{156}
Credit swaps may not provide any other return or basis for enjoyment to holders.\textsuperscript{157}
Furthermore, credit swaps are unfunded credit derivatives and neither party advances principal
amount or invests idle funds when it enters into credit swaps. As a result, entering into a credit
swap does not constitute making investment.\textsuperscript{158}

However, credit swaps may be treated on capital account when they are used to hedge underlying
credit instruments being held on capital account or where a Canadian resident elects in a
prescribed form to have credit swaps treated as capital property.\textsuperscript{159} Generally, credit swaps take
character of underlying credit instruments when they hedge them.\textsuperscript{160} Whether a credit swap
hedges an underlying credit instrument depends on whether sufficient linkage exists between two
instruments.\textsuperscript{161} If the linkage exists, a credit swap hedges an underlying credit instrument and
follows its tax characterization.\textsuperscript{162} If not, it is regarded as an independent transaction carried on
in the course of the taxpayer's business or speculative activity and is held on income account.\textsuperscript{163}

Determination of the linkage is a question of fact that can only be determined on a case-by-case
basis. Canadian case law does not require exact matching between a credit swap and an

\begin{itemize}
\item[\textsuperscript{156}] Richardson & Broadhurst, \textit{supra} note 128 at 125.
\item[\textsuperscript{157}] \textit{Ibid.}
\item[\textsuperscript{158}] Meredith, \textit{Future Directions}, \textit{supra} note 132 at 18:8.
\item[\textsuperscript{159}] Subsection 39(6).
\item[\textsuperscript{160}] Meredith, \textit{Linkage}, \textit{supra} note 132 at 75. See generally Shell, \textit{supra} note 134; Echo Bay Mines Ltd. v. The
Queen, 92 DTC 6437 (FCTD); MacMillan Bloedel Ltd. v. Canada, [990] 90 DTC 6219 (FCTD).
\item[\textsuperscript{161}] Grottenthaler & Henderson, \textit{supra} note 74 at 11:5.
\item[\textsuperscript{162}] Salada, \textit{supra} note 155. The Federal Court of Canada ruled that Salada should treat the gain from the short sale
of futures on income account because it found that there was little or no relationship between Salada’s gain on the
futures contracts and the underlying capital asset. Hence, if the Federal Court of Canada found the sufficient
linkage, it would recognize the capital treatment of gains. The Canadian tax scholars argue that this reasoning of the
Federal Court of Canada recognizes the linkage principle stipulating that tax characterization of a derivative hedging
an underlying capital asset should be held on capital account. See e.g. Grottenthaler & Henderson, \textit{supra} note [8] at
\item[\textsuperscript{163}] Grottenthaler & Henderson, \textit{supra} note 74 at 11:5.
\end{itemize}
underlying credit instrument. The determination is based on comprehensive evaluation of the following facts:

(1) risk exposure: the hedged risk exposure should be clearly identifiable with reference to existing or specific future contractual commitment;

(2) expressed hedge purpose: the transaction should be clearly referred to and identified as a hedge transaction;

(3) factual correlation between a hedge and an underlying transaction: principal amount, maturity, contemporaneousness of dates of entering the agreements. However, this requirement does not require perfect matching in quantum or over time or both;\(^{164}\)

(4) established commercial hedge practice: evidence of past or present normal commercial practice to recognize a particular transaction as a hedge;

(5) management intent: expressed documented hedge intention not compromised during the life of the hedge.\(^{165}\)

It is argued that economic relations between credit swaps and underlying credit instruments and commercial practice of legal documentation of legal swaps will lead the Canadian courts to recognize existence of the linkage between the two transactions for the part of the buyer. Hence, the courts will recognize a hedging character of credit swap transactions for the part of the buyer. First, the buyer is a party to both the underlying credit instrument and the credit swap. It is a creditor under an underlying credit instrument and a transferor of a credit risk arising from an underlying credit instrument to the seller under a credit swap. The underlying credit instrument

\(^{164}\)Richardson & Broadhurst, \textit{supra} note 128 at 125.

brings the credit risk into existence before the parties enter into a credit swap. A credit swap may not be entered into by the parties without the prior existence of an underlying credit instrument. The hedged credit risk exposure is clearly identifiable in a credit swap as the factual correlation exists between the two instruments. Credit swaps are usually documented on the basis of the 2002 ISDA Model Agreement. The 2002 ISDA Model Agreement requires the credit default swap specifies a reference entity and the underlying credit instrument.\textsuperscript{166} Likewise, it requires the total return swap to specify the underlying credit instrument and its financial structure. Further, the mutual payment obligations of the parties are developed with reference to the terms and conditions of the underlying credit instruments. For example, computation of periodic and terminal payments under a total return swap is based on the financial economics of the underlying credit instrument. Second, the hedged purpose of the credit swap is followed from its economic structure as a balancing and compensatory transaction.\textsuperscript{167} Further, it is an established commercial practice to hedge the credit risk under the underlying credit instrument by credit swaps.\textsuperscript{168} Hence, the credit swaps and the underlying credit instruments should meet the expressed hedge purpose test. Finally, the management intent of the buyer is evidenced by the fact that the buyer enters into credit swap which is explicitly designed to transfer the credit risk under the underlying credit instrument.

On the contrary, the seller does not use credit swaps for hedging.\textsuperscript{169} Hence, for the part of the seller, credit swaps are independent transactions to be held on income account.

\textsuperscript{166} Satyajit Das, \textit{Credit Derivatives and Credit Linked Notes}, 2\textsuperscript{nd} ed. (USA: John Wiley & Sons, 2000) at 32.
\textsuperscript{167} See Chapter I of this study.
\textsuperscript{168} See e.g. Morgan, Guide, \textit{supra} note 21 (unnumbered), PWC, Guide, \textit{supra} note 21 at 4, 12.
\textsuperscript{169} See Chapter I of this study.
(b) Timing

Timing rules determine when the parties to credit swaps must account and report their receipts and payments as income (or gains) or deductions (or losses), respectively. The timing is determined by two factors: characterization of a credit swap and a tax status of the taxpayer (financial institution or non-financial organization). The Canadian case law establishes that the determination of profit is a question of law and the goal is to obtain an accurate picture of the taxpayer’s profit for a taxation year.\textsuperscript{170} In ascertaining profit, a taxpayer may use any method of accounting, provided it is consistent with the provisions of the Act, established case law principles and well-accepted business principles.\textsuperscript{171} Hence, the computation of profit for tax purposes may differ from the computation of profits in the financial statements.\textsuperscript{172} The GAAP and other accounting principles may be used as interpretive aid “where the Act is silent or where statutory provisions require interpretation.”\textsuperscript{173} Thus, the timing for tax purposes may differ from the timing for accounting purposes.

(i) Capital Account

If the taxpayer holds a credit swap on capital account, the credit swap is considered a non-depreciable capital property.\textsuperscript{174} If the taxpayer disposes the credit swap, it will realize a capital gain (or capital loss) to the extent that its proceeds of disposition exceed (or are less than) the total of the adjusted cost base to the taxpayer of the credit swap and any expenses incurred in

\textsuperscript{170} Canderel Limited v. R., 98 DTC 6100 (SCC), para 53 [Canderel].
\textsuperscript{171} Ibid.
\textsuperscript{172} Hogg, supra note 110 at 173.
\textsuperscript{173} Ibid.
\textsuperscript{174} Section 54 defines non-depreciable property as: “any property (other than depreciable property), any gain or loss from the disposition of which would, if the property were disposed of, be a capital gain or a capital loss, as the case may be, of the taxpayer.”
respect of the disposition. Disposition of a credit swap takes place when a taxpayer becomes entitled to the gross proceeds from termination of a credit swap. The recognition of capital gains and losses occurs at the time of disposition of the credit swap.

(ii) Income Account

A taxpayer's income for a tax year from a credit swap is the taxpayer's "profit" from the credit swap for the year. The taxpayer determines its profit on realization principle. Gain or loss is considered realized when it is “final, is subject to accurate measurement, and is no longer susceptible to fluctuations in value,” even it is deferred under GAAP. The timing of recognition of payments or receipts follows general principles of commercial accountancy.

Generally, the payments made (or received) by the taxpayer are included (or deducted) in calculating the taxpayer’s income for the year in which the payment is made (or received). If a taxpayer holds a credit swap as inventory of a business, income and losses are recognized on a realization principle and accounted for on an accrual basis. Accrued gains and losses are realized in a tax period in which a credit swap is disposed. If, however, the inventory is used in an adventure or concern in the nature of trade, the taxpayer may not recognize accrued gains or losses.

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175 Paragraphs 3(b), 39(a) and 39(b).
176 Subsection 248(1) and section 54.
177 Section 40.
178 Subsection 9(1).
180 Subsection 9(1).
181 Hogg, supra note 110 at 243.
182 Subsection 10(1.01).
However, the financial institutions are required to use mark-to-market accounting to recognize income and losses.\textsuperscript{183} Thus, the mark-to-market rules override the "realization" principle for financial institutions. They recognize income and loss on a "mark-to-market" basis at the end of each taxation year.\textsuperscript{184}

3. Income Tax Treatment of Credit Swaps

This section analyzes income tax treatment of financial institutions and non-financial organizations.

A. Financial Institutions

The financial institutions account for credit swaps at income account regardless whether they act as the buyer hedging the underlying transactions or as the seller speculating on or trading in credit swaps. This is because they are required to mark credit swaps to market by the Act.\textsuperscript{185} The market value approach would require the financial institution to evaluate credit swaps at market value at the end of each taxation year, rather than at disposition of credit swaps.\textsuperscript{186} The financial institutions are treated as though they had disposed credit swaps at the end of each taxation year for fair market value and then repurchased the credit swap at the end of a taxation year at a cost equal to the proceeds from the disposition.\textsuperscript{187} Gains (or losses) on credit swaps are taxed (or allowed as deduction) at the end of each year. Hence, the mark-to-market accounting eliminates capital treatment for financial institutions.

\textsuperscript{183} Subsections 142.5(1) and 142.5(2).
\textsuperscript{184} Subsections 142.5(1) and 142.5(2).
\textsuperscript{185} See definition of mark-to-market property in subsection 142.1(1) and mark-to-market requirement for financial institutions in subsections 142.5(1) and 142.5(2).
\textsuperscript{186} Subsections 142.5(1) and 142.5(2).
\textsuperscript{187} Subsection 142.5(2).
(a) Credit Default Swaps

The losses arising from advance or periodic payments made by the protection buyer as well as gains (or losses) arising from increase (or decrease) in the market value of CDS are accrued and realized at the end of a taxation year when CDS is deemed disposed. In case of a credit event, the protection buyer includes the default payment received from the protection seller to its balance from the disposition of CDS.\textsuperscript{188} If no credit event happens until the maturity, the protection buyer realizes its losses from termination of CDS at maturity.

Likewise, for the part of the protection seller, gains arising from the advance or periodic payments received from the protection buyer as well as gains (or losses) arising from any increase (or decrease) in the market value of CDS are realized at deemed disposition of CDS at the end of a taxation year.\textsuperscript{189} In case of a credit event, the losses arising from a default payment made by the protection seller are realized at the disposition of CDS.\textsuperscript{190} If no credit event happens until the maturity, the protection seller realizes its gains earned as a result of the termination of CDS at maturity.

(b) Total Return Swaps

The mutual payments, including those arising from appreciation (or depreciation) of the TRS, made by the protection buyer and the protection seller are netted. Any balance after the netting is considered as unrealized gain (or loss) and should be fully included (or deducted) in computing income at the deemed disposition of TRS at the end of the taxation year.\textsuperscript{191} When TRS are terminated at maturity or at credit event, each party should include or deduct the balance.

\textsuperscript{188} Subsection 142.5(1).
\textsuperscript{189} Subsection 142.5(1).
\textsuperscript{190} Subsection 142.5(1).
\textsuperscript{191} Subsection 142.5(1).
remaining after their mutual settlement to its income for a taxation year in which TRS was terminated.\(^{192}\)

### A. Non-financial Organizations

Non-financial organizations hold credit swaps either on capital or income account. If the buyer holds the underlying credit instrument on capital account under the law or by election, it holds the credit swap hedging the underlying credit instrument also on capital account. Consequently, if the buyer holds the underlying credit instrument on income account, credit swaps should also be held on income account. On the contrary, the seller uses credit swaps for speculation and holds them on income account.

#### (a) Credit Default Swaps

If the protection buyer holds CDS on capital account, its paid premium is not deductible and should be recovered from disposition of CDS due to credit event. In case of a disposition of CDS due to a credit event, the protection buyer realizes capital gain to the extent that the payment received from the protection seller exceeds the premium paid by the protection buyer. To the extent that the premium paid exceeds the payment made by the protection seller, the protection buyer will realize a capital loss. In case of a disposition of CDS at maturity, the protection buyer’s proceeds from disposition would be deemed nil and therefore the protection buyer would suffer capital losses. The protection buyer’s taxable capital gain (or allowable capital loss) is a half of its capital gain (loss) from the disposition.\(^{193}\)

If the protection buyer treats CDS as inventory, it recognizes losses from the paid premium on accrual basis. The protection buyer’s expenses should be added to cost of CDS and recovered in

\(^{192}\) Subsection 142.5(1).

\(^{193}\) Paragraphs 38(a) and 38(b).
the year in which CDS was disposed. Its receipts of the protection seller’s default payment should also be attributed to income in the year in which CDS was disposed.\textsuperscript{194} The protection buyer values accrued gains and losses on credit swaps either on a lower of cost or market basis or a mark-to-market basis, depending on the method regularly followed by the taxpayer.\textsuperscript{195}

If the protection seller treats CDS as inventory, it recognizes receipts of advance or interim payments on an accrual basis and includes them into income in a taxation year in which CDS has been sold. However, its default payments to the protection buyer are not deductible because they are contingent.\textsuperscript{196} The protection seller recognizes the premium received as income from property.\textsuperscript{197} However, its default payments made are considered as non-deductible costs, which may be recovered at the time of disposition of CDS.

If either party holds CDS on income account, it may deduct payments made from its income under subsection 9(1) in the taxation year in which the payment was made. Consequently, it should recognize the payment received from the other party in the same taxation year in which it received the payment. Further, if either party uses CDS in the course of an adventure or concern regarding trade, it values CDS at the acquisition cost.\textsuperscript{198} Accordingly, the accrued gains or losses during the term of credit swap are not recognized for tax purposes.\textsuperscript{199} If either party marks the CDS to market, its tax consequences should be the same as for the financial institutions.

\textsuperscript{194} Section 9.
\textsuperscript{195} Subsection 10(1).
\textsuperscript{196} Paragraph 18(1)(e).
\textsuperscript{197} Subsection 9(3).
\textsuperscript{198} Subsection 10(1.01).
\textsuperscript{199} Subsection 10 (1.01).
(b) Total Return Swaps

The mutual periodic payments made by the total return payer and total return receiver should be netted. If the total return buyer accounts TRS on capital account, the positive balance is considered income from property and be included into income for a taxation year in which it was received. If, however, the balance is negative, the total return payer should recover the losses from the proceeds of disposition of TRS. In case of a credit event, TRS is considered disposed by the total return payer. In this case, the protection buyer realizes capital gain to the extent that the payment received from the protection seller exceeds the payment paid by the protection buyer. To the extent that the balance paid out exceeds the payment received from the protection seller, the protection buyer will realize a capital loss.

Either party accounting TRS on income account should recognize positive balance and include it in the income for a taxation year when the balance was received. Consequently, either party should recognize negative balance in a taxation year in which TRS has matured or terminated due to a credit event.200

Either party should account TRS either on a lower of cost or market basis or on a mark-to-market basis, depending on the method regularly followed by the taxpayer. In the former case, the taxpayer recognizes gains and losses on an accrual basis. If either party use mark-to-market accounting, the tax consequences should be the same as for the financial institutions.

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200 Subsection 9(1).
If a party uses TRS in the course of an adventure or concern regarding trade, it is valued at the acquisition cost. Accordingly, the accrued gains or losses during the term of TRS are not recognized.

CHAPTER IV: TAX NEUTRALITY: NORMATIVE ASSESSMENT

A. General

The analysis of the Canadian income tax treatment of credit swaps suggests that it is neutral in most areas of tax regime. First of all, the income tax treatment is quite certain and provides unambiguous rules for taxation of credit swaps. Then, since the end-users and financial intermediaries are corporations that are taxed at a flat rate, the tax planning aiming at achieving a preferable tax rate is not present in Canada. Further, the mandatory use of mark-to-market accounting by financial institutions eliminates the timing and tax characterization tax planning for the part of financial institutions. The financial institutions are deemed to have disposed a credit swap at the end of a taxation year and annually realize accrued gains (losses) and appreciation (depreciation) of credit swaps. Hence, the credit swaps are always taken on income account and are taxed annually. Such treatment eliminates tax characterization and timing tax planning opportunities for the financial institutions. Finally, the Canadian law provides that a credit swap hedging an underlying credit instrument has the same tax treatment as the underlying credit instrument. The rules on recognition of linkage between the two instruments are sufficiently clear to distinguish hedging credit swap transactions. This determination helps to achieve symmetry in taxation of the two instruments which eliminates tax planning. Indeed, as

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201 Subsection 10(1.01).
202 Subsection 10 (1.01).
tax characterization and timing of taxation of the two transactions is the same, any gains (losses) on the one instrument are offset by losses (gains) on the other instruments.

However, there remain areas in which tax neutrality needs to be improved. The tax planning opportunities exist in tax treatment of non-financial organizations. The buyers may have tax characterization and timing options asymmetric to those available to the sellers. The buyers have opportunities to choose between capital or income treatment, while the sellers always treat credit swaps on income account. Furthermore, the parties may select different accounting methods of accommodating and valuing credit swap payments.

B. Symmetry

The analysis provided in Chapter III outlines the following four types of typical credit swap transactions:

<table>
<thead>
<tr>
<th></th>
<th>Protection Buyer/ Total Return Payer</th>
<th>Protection Seller/ Total Return Receiver</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Financial institution</td>
<td>Financial institution</td>
</tr>
<tr>
<td>2</td>
<td>Financial institution</td>
<td>Non-financial organization</td>
</tr>
<tr>
<td>3</td>
<td>Non-financial organization</td>
<td>Financial institution</td>
</tr>
<tr>
<td>4</td>
<td>Non-financial organization</td>
<td>Non-financial organization</td>
</tr>
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</table>

Since Canada has a flat corporate tax rate, tax rate considerations do not affect symmetry between credit swaps and underlying credit instruments or between the parties to credit swaps. Hence, for the purpose of this section tax rates are considered symmetrical.
(a) Symmetry Between the Transactions

In all model transactions, the symmetry between credit swaps and underlying credit instruments is attained. In the first two model transactions, the buyers-financial institutions treat both credit swaps and underlying credit instruments as mark-to-market property. As a result, the two transactions have the same tax characterization and timing rules. Likewise, in the last two model transactions, the buyers-non-financial organizations have the same tax characterization of both credit swaps and underlying credit instruments due to the linkage between the two transactions. Hence, the tax characterization and timing of taxation of credit swaps and the underlying credit instruments are also the same.

(b) Symmetry Between the Parties

In model 1 transactions, the income tax treatment is symmetrical as the characterization and timing rules are similar. This is because both parties treat credit swaps as mark-to-market property and therefore are subject to the same tax characterization and timing rules.

In model 2 transactions, the income tax treatment is not symmetrical, unless non-financial organizations also use mark-to-market treatment to treat credit swaps. While financial institutions accrue unrealized losses and appreciation or depreciation of the credit swaps value in the end of the taxation year or at termination of credit swaps, non-financial organizations realize ordinary income at different tax periods. If they do not treat credit swaps as inventory, they recognize receipts and payments in the same taxation year in which they received or made payments. If, however, they treat credit swaps as inventory, they realize gains (or losses) at the disposition of credit swaps. Hence, the timing of income tax treatment of the parties is not symmetrical.
However, if the non-financial organizations mark the credit swaps to market, the income tax treatment is symmetrical because the tax characterization and timing rules will be the same.

In model 3 transactions, if non-financial organizations mark credit swaps to market, the income tax treatment is also symmetrical because the tax characterization and timing rules are the same (like in model 1 transactions). Otherwise, the symmetry is not attained.

The non-financial organizations may account credit swaps on either of capital or income account. In the former case, the payments made by the non-financial organizations and any negative balance of mutual settlement payments are only realized when credit swaps mature or terminates due to a credit event. On the contrary, the received payments and any positive balance of mutual settlement payments are inclusive to income in a taxation year when the income is received. Only half of capital gains or losses arising from a disposition of a credit swap are taxable. However, the financial institutions, which mark credit swaps to market, realise the accrual gains and losses annually in the end of the taxation year. Thus, the characterization and timing of the parties are not symmetrical since tax characterization and timing rules are different.

In the latter case, the income tax treatment is also not symmetrical. If the non-financial organizations do not treat credit swaps as inventory, they recognize receipts and payments in the same taxation year in which they received or made payments. If, however, they treat credit swaps as inventory, they realize gains (or losses) at the disposition of credit swaps. Hence, the timing of income tax treatment of the parties is not symmetrical.

However, if the non-financial organizations mark the credit swaps to market, the income tax treatment is symmetrical because the tax characterization and timing rules will be the same.
In model 4 transactions, the treatment may still be asymmetrical. The buyer may treat the credit swaps on capital account, while the seller may treat the credit swap on income account. Further, asymmetric treatment is also possible even if both parties treat credit swaps on income account. The timing rules may be different if one party treats the credit swaps as inventory, while the other does not.

The treatment becomes symmetric only if both parties treat credit swaps payments on income account as either inventory or ordinary business proceeds, or as an adventure or concern in the nature of trade.

C. Consistency

The analysis of the Canadian income tax treatment of credit swaps suggests that the national tax policy does not pursue consistency to achieve tax neutrality. The Canadian tax law has long adherence to form over substance concept and “[t]he form over substance doctrine remains law in Canada.”203 Tax liabilities are imposed based on a legal form of the taxpayers’ relationships rather than their commercial nature.204 Ignorance of legal form would give extraordinary power to courts. The courts would be “felt unconstrained by the legal form of the taxpayer’s arrangements, and felt free to impose tax on a different basis.”205 Hence, focusing taxation of credit swap transactions based on their economic substance would not be compliant with the Canadian national tax policy.

However, some commentators argue for taking the consistency approach in achieving tax neutrality in Canada. For example, P. Mark Meredith suggest that “economically equivalent
transactions [should be] subjected to equivalent tax treatment’’ so that “the form for [the] business transactions is not distorted by different tax treatment.”

D. Balance

In the Canadian context, the objectives of balance and symmetry between the parties are identical. Unlike the symmetry approach which is concerned with identical tax rates, the balance approach is not concerned with tax rates in respect to risky returns on derivatives. However, in Canada, taxpayers have flat corporate tax rate so that any difference between two approaches is eliminated.

Hence, the study’s findings on the symmetry of the income tax treatment of credit swaps are applicable to make conclusion on whether the balance has been achieved.

E. Certainty

Although the Canadian tax law contains no specific statutory rules regulating credit swaps, it provides for the unambiguous income tax treatment of credit swaps. The developed principles of private and tax law have established tax regime with certainty sufficient for effective use of credit swaps. For example, The Act provides for clear operational tax concepts (property, inventory, etc.) that are used in taxation of credit swaps. The case law has developed the concept of hedging that allow to identify the linkage between a credit swap and an underlying credit instrument for the purpose of characterizing credit swap transaction as on income or capital account. The “form over substance” and “legal substance” doctrines provide for easy identification of credit swaps transactions for tax purposes. The acceptance of the GAAP accounting rules for determining tax law liabilities brings additional clarity to the tax regime.

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206 Meredith, Future Directions, supra note 132 at 18:2.
207 Ibid. at 18:21.
The tax regime is particularly certain for financial institutions which treat credit swaps under the well-defined tax statutory concepts of mark-to-market property and rules for its taxation.

CHAPTER V: Proposals to Enhance Tax Neutrality

This chapter suggests proposals for enhancement of neutrality of income tax treatment of credit swaps to which a non-financial organization is a party. The proposal is based on the assumption that any improvement of current tax regime should be gradual and focused entirely on credit swaps. The incremental and focused strategy of reform is more administrable because tax policy makers “normally proceed in small steps” and “typically focus on a particular derivative.”

The proposal focuses on achieving tax symmetry and improving certainty between the parties. It has been developed on the basis of David Schizer’s suggestions on implementation of a balance approach in the United States. The use of the balance approach is justified because, in the Canadian context, the only difference between the symmetry and balance approaches is focus on tax rates. The symmetry approach focuses on tax rate, while the balance approach disregards it. However, since in Canada corporations face a flat corporate tax rate, this distinction is not relevant. Hence, the balance approach may be used to attain tax symmetry.

Working on consistency of tax treatment seems not productive. The Canadian tax law establishes tax liability based on a legal form of credit swaps, rather than their commercial substance. The principle “form over substance” was implemented to limit the courts’ power to consideration of legal issues only. Tailoring tax treatment based on financial economics of credit swaps would not be possible without changing this fundamental principle of the Canadian law. Hence, focusing the enhancement of tax neutrality on consistency would not be reasonable.

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208 Schizer, supra note 79 at 1916.
A. Achieving Symmetry Between the Parties

The optimal way to achieve consistency is to introduce a mandatory mark-to-market accounting of credit swaps to non-financial organizations. The non-financial organizations currently have an option to mark credit swaps to market. Therefore, the mandatory use of mark-to-market accounting would not bring any unintended distortions to the Canadian tax system.

The mark-to-market accounting would be highly effective in eliminating tax characterization and timing options. The taxpayers would treat credit swaps only on income account. Further, they would no longer have a control over the timing of their tax payments. The taxpayers will value the credit swaps in the beginning and at the end of the year, and the difference would become a taxable income or deductible loss. Hence, the taxpayers would be denied the opportunity to keep appreciated positions or to sell depreciated positions on credit swaps.

Mark-to-market treatment of credit swaps will not entail additional high compliance and monitoring costs. The common objections to mark-to-market accounting include the taxpayer’s compliance costs and liquidity as well as the government’s administrative costs. The taxpayers could incur additional costs of annual valuation of derivatives or be not liquid enough to pay tax before they dispose selling the investment. The government could incur additional administration costs related to monitoring of the self-evaluation made by a taxpayer.

However, it is submitted that these objections could not be strong in respect to credit swaps. Since in the most cases one party to credit swaps is a financial institution, which is already required to mark the credit swaps to market, the value of the credit swaps should be available to their non-financial counterparties. The financial institutions could be required to share their valuation with non-financial counterparties. Furthermore, since only corporations with access to
information participate in credit swap market, the taxpayers, in theory, should be capable of
determination of value at law cost. Further, the liquidity risk would not be strong because only
the financially-sound corporations participate in credit swaps. The government would not
bear high administrative costs as credit swaps are easily identifiable transactions and it would be
easy to apply mark-to-market accounting to them. In addition, the government exercises a strong
control over financial institutions and could use the information gathered from the financial
institutions to monitor the non-financial corporations.

B. Improving Certainty

It is submitted that the optimal way to improve certainty would be for CRA to issue an
administrative guidance on credit swaps clarifying its current tax treatment of credit swaps. The
rationale behind this a theoretical proposition that “binding principles backing non-binding rules
will be more certain … if they are embedded in institutions of regulatory conversation that foster
shared sensibilities.” The Canadian law has well-developed principles governing tax
treatment of credit swaps. It is submitted that these principles should back non-binding rules of
the CRA administrative guidance. Certainty would be enhanced through shared assumptions of
the taxpayers and CRA on tax treatment of credit swaps which would be developed during
discussion on the administrative guidance. The administrative guidance would clarify and unify
the understanding of current tax treatment by CRA and the credit swap market participants. The
clarified uniform understanding would reduce CRA’s administrative costs of monitoring and
enforcement of the current tax treatment and the market participants’ compliance costs.

209 See Chapter I supra.
210 Braithwaite, supra note 118 at 71.
Issuing a separate guidance on the credit swaps would be justifiable given the significant size of the credit swaps market. Furthermore, the credit swaps are basic types of derivatives with the established commercial practice and custom. So, issuance of such guidance would not undermine the CRA future position as the case may with more sophisticated or newly developed forms of derivatives. Finally, CRA has already issued such guidance on other types of derivatives, including swaps, and issuing guidance on credit swaps would be compliant with its administrative practice.

Other measures suggested by David Schizer– zero tax rate and stated term approach- would be less efficient. The stated – term approach would require the government to introduce the maximum maturity of derivatives and the taxpayers would try to find tax planning opportunities to adjust the definition of maturity to delay the maturity.211 Furthermore, the stated term approach would also require the government to delay collecting taxes from the taxpayers until the maturity of credit swaps. Indeed, if a taxpayer terminates a two-year derivative at a gain after one year, tax is not due for one year. A zero tax rate approach would not be suitable as it would violate an ability-to-pay principle of the Canadian tax law.

CONCLUSION

Credit swaps contribute to promoting efficient allocation of financial resources in global and national capital markets. The efficiency of credit swaps transactions requires neutral tax regime. In theory, the neutral tax regime does not provide the parties with tax planning opportunities in structuring credit swap transactions so that their business decision-making are not distorted by tax considerations.

211 Schizer, supra note 79 at 1922.
The study examines tax neutrality of income tax treatment in Canada in domestic context. It analyses applicable tax regime to find out whether the tax regime is certain and whether market participants have tax planning discretion in choosing tax characterization, timing and tax rates. Tax planning opportunities have been studied through the lenses of symmetry, consistency and balance concepts. The study argues that the suitable objective of the Canadian tax policy to enhance tax neutrality would be symmetry. In the Canadian context, symmetry has the same content as balance. The only difference between symmetry and balance is its focus on tax rates. However, the Canadian tax law has a flat corporate tax rate and therefore the taxpayers do not have any tax planning discretion in respect to tax rates. Consistency would not be suitable objective of the Canadian tax policy because the Canadian law is based on the “form over substance” principle. The principle requires the courts to make judgments on the taxpayers’ transactions based on their legal form, rather than economic character.

The study finds that the current tax regime is only partially neutral. The income tax treatment is quite certain as it provides for unambiguous rules and concepts. Further, symmetry has been achieved in respect to tax treatment of credit swaps and underlying credit instruments. However, the symmetry has not been achieved in treatment of the parties to credit swaps. While symmetry has been accomplished in taxation of credit swaps entered into between the financial institutions, it was not accomplished in taxation of credit swap transactions with participation of non-financial organizations. The mandatory use of mark-to-market accounting eliminates tax planning opportunities for financial institutions. However, symmetry has not been achieved in respect to credit swaps to which non-financial organizations are the parties. When they enter into credit swap transactions with financial institutions, the asymmetric treatment of the parties exist, unless the non-financial organizations also mark credit swaps to market. Furthermore,
various asymmetric patterns exist when the non-financial organizations enter into credit swaps with each other.

To enhance tax neutrality, the study proposes to improve certainty and symmetry of income tax treatment. It argues that CRA should clarify the existing tax regime by issuing an administrative guidance on credit swaps. Further, to improve symmetry of credit swaps transactions, the government may introduce mark-to-market accounting treatment of credit swaps to non-financial organizations. If it is introduced, all market participants would account credit swaps on income account and realize income and losses annually. Hence, such measure would eliminate tax characterization and timing tax planning options for the non-financial organizations.
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