MONTRÉAL EXCHANGE

Canadian Income Tax Overview of Dividend Index Futures

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Table of Contents

1. Introduction

The purpose of this Appendix is to provide a general overview of the Canadian income tax considerations applicable to a holder of dividend index futures. This Appendix discusses the Canadian income tax consequences for Canadian and non-resident holders who deal at arm's length and are not "affiliated" within the meaning of the Income Tax Act (Canada) (the "Act") with TMX Group Limited and/or Bourse de Montréal Inc.

This Appendix does not apply to a holder: (i) that is a "financial institution" (as defined in the Act for the purposes of the mark-to-market rules), (ii) an interest in which is a "tax shelter investment" (as defined in the Act), or (iii) that is a "specified financial institution" (as defined in the Act).

This Appendix is based upon the provisions of the Act and the regulations thereunder (the "Regulations") in force on the date hereof and an understanding of the current administrative practices and assessing policies of the Canada Revenue Agency ("CRA"). It takes into account all specific proposals to amend the Act and Regulations publicly announced by or on behalf of the Minister of Finance (Canada) prior to the date hereof (the "Proposed Amendments") and assumes that all Proposed Amendments will be enacted in the form proposed. However, no assurances can be given that the Proposed Amendments will be enacted as proposed, or at all. It does not otherwise take into account or anticipate any changes in law or administrative or assessing practice, whether by legislative, regulatory, administrative or judicial action, nor does it take into account provincial, territorial or foreign income tax legislation. Subsequent developments could have a material effect on the following description.

This Appendix is of a general nature only and is not intended to be, legal or tax advice to any particular holder and no representation is made with respect to the Canadian income tax consequences to any particular holder. It is not exhaustive of all Canadian income tax considerations. Accordingly, prospective holders should consult their own tax advisors with respect to their particular circumstances.

2. Dividend Index Futures

2.1 General Description

Dividend index futures are derivative contracts which obligate parties to transact at a predetermined date and price in the future. They are designed to allow investors to access the market without actually holding the underlying investments.

Dividend index futures track performance of the dividend payout on a referenced portfolio of stocks, which is known as an index, for a defined period. At each ex-dividend dates, the monetary value of the dividends is converted into index points and added to the index. These points, which represent the value of the index, would be realized upon maturity. As such, the index is representative of the cumulative value of the dividends paid over a defined period. At the start of the next period, the index is reset to zero so that it reflects the dividend payout in discrete periods that coincide with the maturity of the futures.

2.2 Settlement

Generally, holders of dividend index futures may settle their contracts in one of the following ways:

a) Holders may settle the futures upon maturity;

b) Holders may sell their positions prior to maturity as there is no obligation to hold dividend index futures until maturity; or

c) If holders wish to hold their position beyond the maturity, they will sell the contract initially purchased and take the same position on the following contract period.

The sellers of a futures contract can also close their positions by buying back the contract sold. This would also lead to a settlement of the contract.

3. Taxation of Holders Resident in Canada

3.1 Characterization

The first step is to assess how to characterize the transaction, in particular, whether it is regarded as on capital or on income account. This distinction has material tax consequences to holders, which are summarized as follows:

- Where the transaction is considered an income transaction, holders must recognize the full amount of the gain or loss for tax purposes. On the other hand, where the transaction is considered on an account of capital, only one-half of the gain is taxable and must be included in income, and similarly, one-half of the loss constitutes a deductible capital loss.

- Losses that are on income account can be used to offset income from any source, such as business income, employment income or taxable capital gains. However, deductible capital losses can only be used to offset taxable capital gains. In addition, unused losses that are on income account may be used to offset taxable income in the three preceding taxation years or the twenty subsequent taxation years. Unused deductible capital losses can be used to offset only taxable capital gains realized in the three preceding taxation years or any subsequent taxation year.

Certain taxpayers may make an irrevocable election for tax purposes to treat all Canadian securities the taxpayers own as capital properties.[1] A Canadian security is generally defined to include a share of the capital stock of a corporation resident in Canada, a unit of a mutual fund trust or a bond, debenture, bill, note, mortgage, hypothecary claim or similar obligation issued by a person resident in Canada.[2] Accordingly, dividends index futures do not meet the definition of Canadian securities. It is therefore necessary to consider the facts to determine whether a transaction is on income account or capital account.

1 Subsection 39(4) of the Act. This election is made by filing form T123 – Election on disposition of Canadian securities. Quebec residents will also have to file form TP-250.1 – Election respecting the disposition of Canadian securities.

2 Subsection 39(6) of the Act.

The Act does not contain any specific provision with respect to computation of income derived from dividend index futures. A limited number of court cases address some of the issues, and the CRA has published a few administrative positions on topics that include stock index futures.

While not particularly addressing dividend index futures, the CRA's comments in determining characteristics of gains or losses in the context of transactions in securities may be referred to as a guidance.[3] The CRA notes that for transactions in securities, generally, "course of conduct" and the "intention" of entering a transaction should be examined in determining whether the transaction is on income account or capital account. The CRA further comments that where the whole course of conduct indicates that:

a) a person is disposing of securities in a way capable of producing gains and with that object in view, and

b) the transactions are of the same kind and carried on in the same way as those of a trader or dealer in securities,

the proceeds of sale are normally considered to be income from a business and therefore, on income account. The CRA also lists the following factors to be considered in ascertaining whether a person's course of conduct indicates the carrying on of a business:

a) frequency of transactions: whether there is a history of extensive buying and selling of securities or of a quick turnover of properties,

b) period of ownership: whether securities are owned only for a short period of time,

c) knowledge of securities markets: whether the person possesses knowledge of or experience in the securities markets,

d) whether security transactions form a part of the person's ordinary business,

e) time spent: whether a substantial part of the person's time is spent studying the securities markets and investigating potential purchases,

f) financing: whether security purchases are financed primarily on margin or by some other form of debt,

g) advertising: whether the person has advertised or otherwise made it known that he is willing to purchase securities, and

h) in the case of shares, their nature: whether speculative in nature or of a non-dividend type.

The CRA has also commented on whether an individual trading in stock index futures should be taxed on account of income or capital.[4] Trading in stock index futures would normally be taxed on income account, unless, for example, it relates to the acquisition of capital. Generally, an individual who makes trades in stock index futures every day, particularly where those trades constitute the major source of income to that individual, will be taxed on the profit on account of income.

In another document, the CRA provided its view on classification of gains or losses where the situation in question involves a proposed mutual fund replicating the performance of an investment in publicly traded stocks that are tracked by a recognized stock index.[5] In that particular situation, the transaction would be accomplished through a combination of an investment in Canadian dollar denominated treasury bills issued by Canadian governments together with the purchase of publicly traded futures contracts representing the particular stock index. The futures contracts would be disposed of prior to the contracted date of settlement resulting in a gain or loss to the extent that the proceeds of disposition are greater or less than the cost of the contract.

3 CRA, Interpretation, IT-479R, "Transactions in securities", February 29, 1984 [revised by Special Release dated February 21, 1985].

4 CRA, Views 2004-0101161E5, "Trading in stock index futures", January 12, 2005.

5 CRA, Views 9326225, "Gains and losses on stock index futures", March 7, 1994; CRA, Views 9407005, "Gains and losses on stock index futures", March 25, 1994.

The taxpayer put forward the general presumption that, because of the whole conduct of the taxpayer in entering into a "synthetic" composite instrument designed to replicate the holding of the actual stocks which are tracked by the stock index, any gains realized thereon should be on account of capital, similar to the treatment accorded a passive holder holding the actual stocks. However, the CRA stated that the characterization of the gains and losses is a determination that must be made on the facts of each particular case. In the circumstances described, the CRA was of the view that the holding of the stock index future would be more indicative of an adventure in the nature of trade and would, consequently, fall within the ambit of a "business" as defined in subsection 248(1) of the Act. The CRA further commented that although it would not unequivocally dismiss the view that gains or losses on such instruments could, in certain circumstances, be considered to be on account of capital, in the CRA's view, there would be a presumption that such gains or losses would be derived from an adventure in the nature of trade.

While the determination of the characterization requires complex analysis, applying a consistent tax filing position may help holders to reduce the risk of a challenge by the CRA.

3.2 Income Transactions

As discussed above, holders of dividend index futures may settle their positions in different ways. Holders may settle their positions upon maturity or sell their positions prior to maturity. If holders wish to hold their position beyond the maturity, they will sell the contract initially purchased and take the same position on the following contract period. The sellers of a futures contract can also close their positions by buying back the contract sold. This would also lead to a settlement of the contract.

Generally, income or loss of the holders will be recognized upon settlement of their positions. The entire income or loss must be recognized unlike capital gains or capital losses.

The following summarizes the potential income tax considerations:

Upon acquisition	Brokerage fees or other costs related to acquisition of the future are added to the cost of the future itself. To the extent the holder owns other futures contracts with the exact same terms, the cost of the contracts is averaged on a weighted basis. For investors who wish to hold a position beyond the expiration date and "roll" their initial position, the costs of purchasing the subsequent position would form the cost of the subsequent position.
Holding period	During the holding period, the value of the dividend index futures contracts may fluctuate. These fluctuations of the value may generate income or loss to the extent the value exceeds costs and vice versa, which are commonly referred to as "mark-to-market" gains or losses. These mark-to-market gains or losses are generally considered unrealized for tax purposes. Please also see the discussion under 3.3 Mark-to-Market Election.
Upon settlement	Upon settlement, the excess of the proceeds over costs of acquisition as well as other settlement or sale related costs incurred is included in taxable income or the excess of all costs over proceeds may be deducted. Where holders intend to hold their positions beyond maturity, they will sell the contract initially purchased and take the same position on the following contract period. Income or losses must be recognized upon the sale of each contract for tax purposes. Please also see discussion under 3.6 Stop-Loss Rules for important considerations regarding recognition of losses.

3.3 Mark-to-Market Election

Holders may make an election for tax purposes to recognize mark-to-market gains or losses on eligible derivatives on a current basis.[6] An eligible derivative generally includes a swap agreement, a forward purchase or sale agreement, a forward rate agreement, a futures agreement, an option agreement or a similar agreement that meets certain conditions.[7] In particular, the agreement must not be held on capital account and the agreement must have a readily ascertainable market value. Accordingly, dividend index futures may be considered eligible derivatives for the purposes of the election. Once a holder has elected, mark-to-market gains and losses on dividend index futures would be recognized on a current accrual basis for tax purposes even though the futures may not have been settled in the current taxation year. It is important to note that once the election is made, it will be irrevocable unless the consent of the CRA is obtained.[8]

3.4 Capital Transactions

For transactions on capital account, tax consequences arise to holders upon settlement of the dividend index futures. Where holders sell the futures prior to maturity, a disposition occurs at the time the sale settles. In the case where holders hold their positions beyond the maturity, a disposition occurs for tax purposes upon the settlement of each contract in the series. As noted above, for capital transactions, one half of the gains or losses must be recognized for tax purposes upon disposition.

The following summarizes the potential income tax considerations:

Upon acquisition	Brokerage fees or other transaction related costs related to acquisition of the futures are added to the cost of the future itself. To the extent the holder owns other futures contracts with the exact same terms, the cost of the contracts is averaged on a weighted basis. For investors who wish to hold a position beyond the expiration date and "roll" their initial position, the costs of purchasing the subsequent position would generally form the acquisition cost of the subsequent position.
Holding period	During the holding period, the value of the dividends index futures contracts may fluctuate. These fluctuations of the value may generate income or loss to the extent the value exceeds costs and vice versa, which is commonly referred to as "mark-to-market" gains or losses. These mark-to-market gains or losses are generally considered unrealized for tax purposes. Please also see the discussion under 3.3 Mark-to-Market Election.
Upon settlement	Upon settlement, capital gains or losses are computed as proceeds minus costs of acquisition. Where holders intend to hold their positions beyond maturity, they will sell the contract initially purchased and take the same position on the following contract period. As a result, capital gains must be recognized upon the sale of each contract for tax purposes. Please see discussion under 3.6 Stop-Loss Rules for important considerations regarding recognition of capital losses.

3.5 Simplified Examples

The following illustrates simplified examples with different scenarios:

On January 1, an investor purchases a dividend index future at a price of $35. The investor also pays $1 for brokerage fees and other acquisition costs.

6 Subsection 10.1(1) of the Act. This election is made by filing form T217, Election, or Revocation of an Election, to use the Mark-to-Market method.

7 Subsection 10.1(5) of the Act.

8 The revocation would be made using the form T217, Election, or Revocation of an Election.

During the holding period, the value of the dividend index future may fluctuate. For the purposes of the example, a point in time is used to illustrate the tax treatment of the fluctuation of the value.

The investor does not make an election for tax purposes to recognize mark-to-market gains or losses on eligible derivatives on a current basis.

Scenario 1: Income or Capital Gain

On July 1, the price of the dividend index future increases to $37.

Prior to the maturity date, the investor sells the dividend index for $38.

Scenario 2: Income Loss or Capital Loss

On July 1, the price of the dividend index future decreases to $34.

Prior to the maturity date, the investor sells the position for $33.

	Scenario 1: Income or Capital Gain	Scenario 2: Income Loss or Capital Loss
January 1	• Cost of the future = $36 ($35 + $1) • Brokerage fees and other acquisition costs of $1 are not expensed but added to the cost	• Cost of the future = $36 ($35 + $1) • Brokerage fees and other acquisition costs of $1 are not expensed but added to the cost
July 1	• Unrealized mark-to-market gain = $1 ($37 - $36) • Market-to-market gain is not recognized for tax purposes as no election is made	• Unrealized mark-to-market loss = $2 ($34 - $36) • Market-to-market loss is not recognized for tax purposes as no election is made
Upon sale	**Income Gain** • Income gain = $2 ($38 - $36) • Entire income gain is included in taxable income **Capital Gain** • Capital gain = $2 ($38 - $36) • One half of capital gain is included in taxable income as a taxable capital gain	**Income Loss** • Income loss = $3 ($33 - $36) • Entire loss may be used to offset taxable income from other sources. Please see discussion under 3.6 Stop-Loss Rules for important considerations regarding recognition of losses. **Capital Loss** • Capital loss = $3 ($33 - $36) • Capital losses may be used to offset capital gains in the current year, the preceding three years or a future year. Please see discussion under 3.6 Stop-Loss Rules for important considerations regarding recognition of losses.

Scenario 3: Rolling Position

The investor decides to hold the position subsequent to the maturity date. In order to do this, the investor settles the initial position for $39 upon maturity and purchases a new position on the next business day for $35 plus brokerage fees and other acquisition costs of $1.

Scenario 3: Rolling Position

Upon settlement of initial position	• Income or capital gain = $3 ($39 - $36) • Where the transaction is considered on income account, entire income gain is included in taxable income • Where the transaction is considered on capital account, one half of capital gain is included as a taxable capital gain in taxable income
Upon acquisition of new position	• Cost of dividend index future = $36 ($35 + $1) • Brokerage fees and other acquisition costs of $1 are not expensed but added to the cost

Scenario 4: Multiple Positions

On January 2, the investor purchases an additional identical[9] dividend index future for $37 and incurs another $1 in brokerage fees and other acquisition costs. Prior to maturity, the investor sells the first dividend index future for $39. In addition, the investor sells the second dividend index future prior to maturity for $40.

Scenario 4: Multiple Positions

Upon acquisition	• Cost of each dividend index future = $37 (($35 + $1 + $37 + $1) / 2) • In calculating the cost of each identical property in the group, the average cost is calculated by dividing the total cost of identical properties purchased by the total number of identical properties owned • Brokerage fees and other acquisition costs of $2 are not expensed but added to the cost
Holding period	• Mark-to-market gain is not applicable as no election was made.
Upon sale of first position	• Income or capital gain = $2 ($39 - $37) • Where the transaction is considered on income account, entire income gain is included in taxable income • Where the transaction is considered on capital account, one half of capital gain is included as a taxable capital gain in taxable income
Upon sale of second position	• Income or capital gain = $3 ($40 - $37) • Where the transaction is considered on income account, entire income gain is included in taxable income • Where the transaction is considered on capital account, one half of capital gain is included as a taxable capital gain in taxable income

9 Generally, properties of a group are considered to be identical if each property in the group is the same as all the others.

3.6 Stop-Loss Rules

Holders should be cautious about various stop-loss rules applicable to dispositions of property that are described in an inventory of a business that is an adventure or concern in the nature of trade[10], as well as dispositions of a capital property. The stop-loss rules generally apply where holders or an "affiliated person"[11] acquire the transferred property or an identical property within a period beginning 30 days before and ending 30 days after the transfer. If these rules apply, holders may not recognize losses in the current period, rather, the losses are recognized when the substituted property is no longer owned by the holders or an affiliated person.

Properties are generally considered identical properties when they are the same in all material respects, so that a prospective buyer would not have a preference for one as opposed to another. To determine whether properties are identical, it is necessary to compare the inherent qualities or elements which give each property its identity. Such a determination is a question of fact which must be decided on the basis of the relevant details in each situation.

Generally, amongst other exceptions, to the extent that a holder has elected as discussed in 3.3 Mark-to-Market Election, the stop-loss rules should not apply in determining the amount of a taxpayer's profit or loss in respect of such eligible derivatives as a result of deemed dispositions rules prescribed under the Act.[12]

3.7 Character Conversion Rules

In general, the "character conversion rules" apply to prevent taxpayers from converting fully taxable ordinary income to capital gains by purchasing or selling capital properties under a "derivative forward agreement", which is generally an agreement to purchase or sell a capital property that meets certain conditions.[13] It may include an agreement to buy or sell a property on a future date, with payments linked to something other than the property's value such as an interest component or dividends on a basket of stocks. Accordingly, it is unlikely that the dividend index futures would be considered as a derivative forward agreement as there is no agreement to purchase or sell a capital property as part of the agreement. The dividend index futures are settled for cash at the time of disposition.

One example targeted by the rules would involve a taxpayer seeking to gain economic exposure to a portfolio of investments that produces fully taxable ordinary income. The taxpayer would enter into an agreement with a counterparty to acquire Canadian securities at a specified future date. The value of the Canadian securities to be delivered to the taxpayer on the settlement of the forward purchase agreement would be based on the performance of the reference portfolio. On the settlement of the forward purchase agreement, the taxpayer would acquire the Canadian securities from the counterparty and then immediately resell them for cash. The taxpayer would make an election to treat its Canadian securities as a capital property, resulting in a capital gain.

As applicable, holders are recommended to consult their own tax advisors to understand the implication of the rules for their circumstances.

3.8 Refundable Tax

Canadian holders that, throughout the relevant taxation year, are "Canadian-controlled private corporations"[14] may be liable for an additional refundable tax in respect of taxable capital gains realized on disposition of their dividend index futures that are held as capital properties.

10 Subsections 18(14) and 18(15) of the Act.

11 Section 251.1 of the Act. Generally, affiliated persons include an individual and a spouse or common-law partner of the individual. A person is also affiliated with a corporation when (1) the person controls the corporation, (2) the person is a member of an affiliated group of persons that controls the corporation, or (3) the person is a spouse or common-law partner of a person in (1) or (2).

12 Paragraph 18(14)(c) of the Act.

13 Definition of "derivative forward agreement" in subsection 248(1) of the Act.

14 Subsection 125(7) of the Act.

3.9 Alternative Minimum Tax

Canadian holders that are individuals and certain trusts may be liable for alternative minimum tax as calculated under the detailed rules set out in the Act on capital gains realized upon disposition or settlement of futures contracts.

The alternative minimum tax is designed to ensure that high income earners pay a minimum amount of tax instead of little or no tax. This is done through a separate tax calculation that takes out various tax preferential items which would lower a taxpayer's taxable income.

4. Qualified Investments, Registered Retirement Savings Plan Accounts and Tax-Free Savings Accounts

Certain investments may qualify as a "qualified investment" for registered retirement savings plans ("RRSPs") and tax-free savings accounts ("TFSAs") purposes.[15] A security that is listed on a designated stock exchange may be considered a qualified investment, however, the definition of a security excludes futures contracts or other derivative instruments in respect of which the holder's risk of loss may exceed the holder's cost.[16] Accordingly, certain futures contracts may be purchased within an RRSP or TSFA provided that the holder's risk of loss on such contracts does not exceed the holder's cost of acquiring the contracts.

5. Taxation of Non-resident Holders

Generally, a non-resident holder should not be subject to tax under the Act in respect of any gain realized upon settlements of its dividend index futures nor should losses arising therefrom be reported under the Act unless such dividend index futures constitute "taxable Canadian property".[17] The interest in the dividend index futures would generally not constitute "taxable Canadian property" as the non-resident holders do not have an interest in the underlying shares. We recommend that non-resident holders consult their own tax advisors to determine the tax consequences of holding the futures.

6. Conclusion

Complex analysis may be required to determine the tax consequences of dividend index futures, particularly in regard to the characterization of gains and losses as being on income account or capital account. As a result, holders should obtain individual advice adapted to their own situation from an independent source.

This document is of general nature and cannot serve as a substitute for the advice of a qualified tax adviser.

15 Definition of "qualified investment" in subsection 146(1) of the Act and definition of "qualified investment" in subsection 204(1) of the Act.

16 Paragraph (d) of the definition of "qualified investment" in subsection. 204(1) of the Act.

17 Definition of "taxable Canadian property" in subsection 248(1) of the Act.

For more information

Please contact Montréal Exchange if you have any additional questions or require further clarification.

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