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Timothy Edgar
Osgoode Hall Law School of York University, tedgar@osgoode.yorku.ca

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Risk-Based Overrides of Share Ownership as Specific Anti-Avoidance Rules

Tim Edgar*

PRÉCIS
Le présent article permet de conceptualiser les dispositions législatives récemment adoptées relativement aux « contrats dérivés à terme » (CDT), aux « arrangements de disposition factice » (ADF) et aux dispositions proposées ultérieurement quant aux « arrangements de capitaux propres synthétiques » (ACPS), en tant qu’exemples de règles anti-évitement qui constituent une dérogation fondée sur le risque au concept de l’actionnariat aux fins d’une loi d’intérêt privé, au moment de conférer des attributs fiscaux. Même si ces règles anti-évitement visent des opérations distinctes sans lien entre elles, elles partagent certaines grandes caractéristiques. Avant toute chose, elles prennent la forme de règles détaillées, plutôt que de normes exprimées de façon générale, et elles comportent une exposition au risque, de manière explicite ou implicite, en tant que procuration pour le contribuable, dans le cadre d’un éventail d’opérations ciblées. L’auteur soutient que cet ensemble de dérogations à la propriété fondées sur le risque, dans la Loi de l’impôt sur le revenu, pourrait être refondu en approchant de manière uniforme le ciblage de chacune des opérations pertinentes. Cette approche exige que l’exposition au risque soit spécifiée explicitement en tant que pourcentage, ce qui rend possible un ciblage plus précis (particulièrement si cette spécification diffère en fonction des dérogations) qu’à l’heure actuelle, alors que sont utilisées des formules verbales imprécises ou des procurations en matière d’exposition au risque. Mais des spécifications précises nécessitent une évaluation précise de l’exposition au risque, ce qui pose certains défis pratiques et laisse aussi entendre certaines limites pratiques. De plus, les limites établies dans la Loi de l’impôt sur le revenu qui sont la source de la substitution fondée sur des considérations fiscales posent particulièrement problème lorsqu’il

* Of Osgoode Hall Law School, York University, Toronto (e-mail: tedgar@osgoode.yorku.ca). Earlier versions of this article were presented at the Tax Law and Policy Workshop, Faculty of Law, University of British Columbia and the Tax Policy and Research Symposium—Perspectives from Law and Accounting, held at the Waterloo Centre for Taxation in a Global Economy, University of Waterloo and sponsored by Deloitte LLP. The author would like to thank workshop and symposium participants for comments and suggestions. The article benefited in particular from the input of Neil Brisley, Hugh Chasmar, Wei Cui, Ranjini Jha, Alan Macnaughton, Gordon Mackenzie, and Lindsay Tedds as well as two anonymous reviewers.
s’agit de faire une distinction nette entre les positions fondées sur des considérations fiscales et celles qui ne le sont pas, concernant une propriété caractéristique d’une spécification particulière et qui devrait, idéalement, être appuyée par une norme visant une certaine fin, plutôt que de reposer sur la règle générale anti-évitement de l’article 245 de la Loi. L’auteur laisse entendre qu’en dépit du scepticisme présent dans la documentation, le concept financier de delta fournit un outil de mesure utilisable avec les positions des actions négociées. Ce potentiel n’est pas négligeable, étant donné que les actions négociées seraient le point de mire des opérations d’évitement pertinentes visées par les dérogations fondées sur le risque. En ce qui concerne les autres types de propriété, y compris les actions non négociables, une détermination imprécise de l’exposition au risque faisant appel à des formules verbales et à une norme fondée sur la fin peut être utilisée de préférence à l’ensemble actuel d’approches éclectiques du ciblage des dérogations fondées sur le risque en tant que règles anti-évitement particulières.

**ABSTRACT**

This article conceptualizes recently enacted legislation addressing “derivative forward agreements” (DFAs) and “synthetic disposition arrangements” (SDAs), as well as the subsequently proposed provisions addressing “synthetic equity arrangements” (SEAs), as examples of specific anti-avoidance rules that are risk-based overrides of the concept of share ownership for private-law purposes in the assignment of income tax attributes. Although these specific anti-avoidance rules address discrete and unrelated transactions, they share some broad design features. Most importantly, they take the form of detailed rules rather than generally expressed standards, and they incorporate risk exposure, either explicitly or implicitly, as a proxy for taxpayer purpose for a range of targeted transactions. The author argues that this set of risk-based overrides of ownership in the Income Tax Act could be recast using a uniform approach to the targeting of each of the relevant transactions. This approach involves the specification of a level of risk exposure explicitly as a percentage amount, which holds the possibility of more accurate targeting—particularly if the specification is tailored differently for different overrides—than is currently the case using either imprecise verbal formulas or proxies for risk exposure. Precise specification requires, however, precise measurement of risk exposure, which presents certain practical challenges and suggests some practical limitations. Moreover, boundaries in the tax law that are the source of tax-driven substitution are especially problematic with respect to a bright-line distinction between tax-driven and non-tax-driven positions in property that is characteristic of precise specification and should ideally be backstopped with a purpose-based standard rather than reliance on the general anti-avoidance rule in section 245 of the Act. The author suggests that, despite skepticism in the literature, the financial concept of delta provides a measurement tool that is feasible with positions in traded shares. This potential is not inconsiderable, since traded shares tend to be a particular focus of the relevant set of avoidance transactions addressed by risk-based overrides. For other types of property, including non-traded shares, an imprecise specification of risk exposure using verbal formulas and a purpose-based standard may be used in preference to the existing set of eclectic approaches to the targeting of risk-based overrides as specific anti-avoidance rules.

**KEYWORDS:** RISK n TAX AVOIDANCE n HEDGING n DERIVATIVES n SHARES n OWNERSHIP
INTRODUCTION

The March 21, 2013 federal budget included proposals for specific anti-avoidance rules intended to address what the budget documents refer to as “character conversion transactions” and “synthetic dispositions.” Draft legislative rules were released on September 13, 2013 and subsequently enacted on December 12, 2013. The April 21, 2015 federal budget followed these two legislative initiatives with a similar

1 Canada, Department of Finance, 2013 Budget, Budget Plan, March 21, 2013, at 341-43, and resolution 19 of the accompanying Notice of Ways and Means Motion To Amend the Income Tax Act and Other Tax Legislation.

2 Canada, Department of Finance, “Government of Canada Moving Forward with Its Plan for Jobs, Growth and Long-Term Prosperity,” News Release 2013-117, September 13, 2013, and the accompanying Legislative Proposals Relating to the Income Tax Act, the Excise Tax Act, and the Income Tax Regulations (Ottawa: Department of Finance, September 2013), at clauses 2, 9(3), 24, and 50, proposing the following amendments to the Income Tax Act (RSC 1985, c. 1 (5th Supp.), as amended; herein referred to as “the Act”); paragraphs 12(1)(z.7) and 20(1)(xx); section 80.6; and subsection 248(1) definitions of “derivative forward agreement,” “synthetic disposition,” and “synthetic disposition period”; enacted by SC 2013, c. 40; royal assent December 12, 2013. (Unless otherwise stated, statutory references in this article are to the Act.)
proposal for a specific anti-avoidance rule intended to address “dividend rental arrangements” (DRAs). The definition of a “derivative forward agreement” (DFA) targets character conversion transactions. The definition of a “synthetic disposition arrangement” (SDA) targets synthetic dispositions. The proposed definition of a “synthetic equity arrangement” (SEA) targets DRAs.

Broadly speaking, DFAs, SDAs, and SEAs are examples of synthetic financial instruments, consisting of the combination of long and short positions in legally distinct instruments that provide offsetting cash flows replicating the cash flows associated with a single instrument or transaction the income tax treatment of which is often inconsistent with the sum of the treatments applied to the components of the synthetic. DFAs purport to convert what would otherwise be a non-capital amount associated with a single instrument to a capital amount associated with the synthetic. SDAs purport to lock in unrealized appreciation on an asset without attracting a disposition for income tax purposes. SEAs purport to provide the benefit of dividend tax relief to taxpayers for whom it would otherwise be unavailable. The apparent motivation for the DFA legislation was some well-known structured transactions involving either forward sales or forward purchases of publicly traded shares by mutual funds, in which the price was determined by reference to a portfolio of fixed-income securities. The immediate transactional motivation for the SDA legislation is unclear, given that a variety of transactions purporting to lock in gain without a disposition have been used since at least the mid- to late-1990s.

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3 Canada, Department of Finance, 2015 Budget, Budget Plan, April 21, 2015, at 461-63, and resolutions 31 and 32 of the accompanying Notice of Ways and Means Motion To Amend the Income Tax Act and Other Tax Legislation.

4 Subsection 248(1), definition of “derivative forward agreement.”

5 Subsection 248(1), definition of “synthetic disposition arrangement.”

6 See the notice of ways and means motion, supra note 3, at resolution 32(2).


9 See Wortsman et al., supra note 8, at 8:3 (noting that equity monetization transactions have been used since the 1980s, with a surge in volume associated with rising equity values in the mid- to late-1990s that subsided after the market crash but increased again with a rising equity market just before the financial crisis of 2007-2009). See also Paul D. Hayward, “Monetization, Realization, and Statutory Interpretation” (2003) 51:5 Canadian Tax Journal 1761-1824, at 1769-72 (providing a brief history of the use of monetization transactions in the United States);
apparent motivation for the SEA proposals is certain dividend equivalent payment transactions undertaken by some Canadian banks with the purported result of avoiding the existing purpose-based legislation addressing DRAs. The Department of Finance suggests in the budget documents that all such transactions could be challenged under existing provisions of the Act, presumably including the general anti-avoidance rule (GAAR) in section 245, but that any challenge would be time-consuming and costly, and specific anti-avoidance rules are preferable “to ensure that the appropriate tax consequences apply.”

Both the DFA and the SDA legislation, as well as the SEA proposals, incorporate features of existing legislative templates such as the conversion transaction legislation and constructive sale legislation in the United States, and draft anti-synthetic rules that were proposed, but not enacted, in Australia as part of a larger project on the taxation of financial arrangements. This kind of anti-synthetic legislation ignores the legal form of separate financial instruments as tax-driven structuring in which offsetting cash flows substantially replicate the risk exposure associated with a particular position. Offsetting positions are defined largely through a description of a set of paradigm transactions providing cash flows that are perfect or near-perfect substitutes for the cash flows associated with fixed-payment debt, a disposition of property with accrued gain, or share ownership. The paradigm transactions are defined in terms of a level of risk exposure that is considered indicative of the tax-driven use of a synthetic instrument or transaction. A character conversion rule typically


11 2013 Budget Plan, supra note 1, at 341 and 343; and 2015 Budget Plan, supra note 3, at 461. The same motivation is cited for a series of unrelated specific anti-avoidance rules proposed in the March 2013 budget as well as amendments to section 55 in the 2015 budget to address certain corporate capital gains stripping transactions. For detailed analyses of the possible application of GAAR to DFAs and SDAs, see Wortsman et al., supra note 8, at 8:18-21 and 8:32-37. See also Hayward, supra note 9, at 1802-12 (discussing the possible application of GAAR to equity monetization transactions).

12 Internal Revenue Code of 1986, as amended (herein referred to as “IRC”), section 1258.

13 IRC section 1259.

14 Australia, Department of the Treasury, “Exposure Draft: Income Tax Assessment Act 1997,” subdivisions 230-J (deemed disposal), 230-JA (deemed non-disposal), and 230-JB (deemed gain from financial arrangement). See, in this respect, Australia, Department of the Treasury, “Taxation of Financial Arrangements—Synthetic and Complex Arrangements,” Media Release no. 022, March 26, 2009 (acknowledging that, after consultations on synthetic arrangements, draft provisions released in 2007 for comment were not included in implementing legislation, but stating that the need for special integrity measures to address synthetic arrangements would be monitored against the background of the Australian GAAR).

15 Edgar, supra note 7, at 350-53.
recharacterizes realized capital gain as a non-capital amount. A constructive sale rule typically deems the taxpayer to have disposed of the relevant long position in the appreciated asset for proceeds equal to fair market value, and to have reacquired the asset at a cost equal to those proceeds. Dividend tax relief is typically denied for DRAs and similar transactions that attempt to transfer such relief between taxpayers.

In a recent conference paper, Miller and Milet\(^\text{16}\) provide a thorough technical analysis of the DFA and SDA legislation. This article focuses on an issue that they canvass\(^\text{17}\) and that is the principal targeting feature of the legislation and the SEA proposals: that is, the specification and measurement of a level of risk exposure. This issue is examined here from a wider policy perspective focused on the specification of risk exposure for the purpose of what may be seen as an entire family of specific anti-avoidance rules in the Act that override share ownership as the basis for what Thompson and Weisbach label “the assignment of tax attributes.”\(^\text{18}\) In addition to the DFA and SDA legislation and the SEA proposals, risk-based rules in the Act that override the concept of share ownership include the anti-foreign-tax-credit-trading rule applicable to short-term securities acquisitions,\(^\text{19}\) the dividend stop-loss rules,\(^\text{20}\) the DRA rules,\(^\text{21}\) the wash sale rules,\(^\text{22}\) and the rules governing securities lending arrangements (SLAs).\(^\text{23}\) With the exception of the SLA legislation, these rules use risk exposure, either explicitly or implicitly, primarily as a proxy for taxpayer purpose in identifying positions in shares that are considered to be tax-avoidance transactions intended to separate private-law ownership from economic exposure, but otherwise leave the assignment of tax attributes following ownership as a matter of private law.

This article is motivated by Thompson and Weisbach’s critique of some recent US case law that departs from a formalistic concept of securities ownership as the basis for the assignment of tax attributes. They prefer that such departures be im-

\(^{16}\) Miller and Milet, supra note 8.

\(^{17}\) Ibid., at 10:22-33.


\(^{19}\) Subsection 126(4.2).

\(^{20}\) Subsections 112(3) through (7).

\(^{21}\) Subsections 82(1) and 112(2.3), and subsection 248(1), definition of “dividend rental arrangement.”

\(^{22}\) The wash sale rules also extend to property other than shares. See subsection 13(21.2) (terminal loss denied on a disposition of depreciable property by a person or partnership); subsections 14(12) and (13) (loss denied on a disposition of eligible capital property by a corporation, partnership, or trust); subsections 18(13) through (16) (loss on a disposition of inventory denied); subsections 40(3.3) through (3.5) (capital loss denied on a disposition by a corporation, partnership, or trust); and subparagraph 40(2)(g)(i) and section 54, definition of “superficial loss” (capital loss denied on a disposition by an individual other than a trust).

\(^{23}\) Section 260.
implemented through targeted legislative overrides, but they do not explore the design of those overrides. In the context of hedged and derivative positions in shares, this article considers how the category of such legislative overrides that are risk-based can be specified in an admittedly tentative effort to improve target-effectiveness with a tolerable level of administrative and compliance intensity. In this respect, the article explores three claims.

The first is that a single approach could be developed for the articulation of the set of risk-based anti-avoidance rules in the Act, in an attempt to lower costs of tax administration and compliance. Some differences in approach may be defensible, however, to tailor application to the paradigm tax-avoidance transactions that otherwise attempt to manipulate the private-law concept of share ownership in the assignment of tax attributes.

The second claim is that a required level of risk exposure could be specified explicitly as a percentage amount across all of the risk-based overrides in an attempt to improve their target-effectiveness. An important constraint on realization of this desirable policy feature is a lack of any systematic empirical evidence regarding the boundary between tax-driven and non-tax-driven positions in shares that is defined by risk-based overrides. Given this lack of systematic evidence, the policy maker is left with only unsatisfactory anecdotal evidence that may indicate the general direction in which targeting could be improved. Precise specification also requires the use of a targeted purpose-based standard to suppress problematic discontinuities where small changes in the level of risk exposure could otherwise result in disproportionate changes in tax treatment.

The third claim is that the measurement of risk exposure could be based on the financial concept of delta. Delta is a measurement tool used by options traders to calculate the rate of incremental price change between a derivative instrument and an underlying asset. Although noted in some of the literature, the possible use of delta for tax purposes tends to be rejected as too administrative- and compliance-intensive. Yet delta is explicitly required to be used to measure risk exposure for

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the purpose of the Australian anti-dividend-credit-trading rules\textsuperscript{25} and in the US proposed regulations under the dividend equivalent payment rules.\textsuperscript{26} This limited use of delta may indicate that any administrative and compliance burden is at least not prohibitive for those risk-based overrides that can be seen to require a more precise specification of risk exposure as a targeting mechanism than can otherwise be realized using standard verbal formulas. Because of limited availability of price data, however, the use of delta may not be feasible for positions in non-traded shares as well as property other than shares that is subject to certain of the risk-based overrides. A legislative alternative to precise specification as a percentage amount using a delta-based measure would combine an expression of risk exposure using an imprecise verbal formula with a purpose-based inquiry.

This article is limited to consideration of the specification of risk exposure as a targeting mechanism under risk-based specific anti-avoidance rules that override share ownership in the assignment of tax attributes. Although there are other features of risk-based overrides that also have a targeting effect, the specification of a level of risk exposure is the most significant targeting feature common to all such overrides in a tax-avoidance context and warrants an extended policy analysis not found in the existing literature. Abstracting from the other features of these risk-based overrides allows for this more policy-intensive treatment, although there is some consideration of these features targeting overlays of the specification of risk exposure. Moreover, because the targeting role is quite different in a non-avoidance context, the article does not address the specification of risk exposure for other overrides, such as the SLA legislation, which are intended to clarify the treatment of transactions in shares that are not tax-driven; nor is there any discussion of the policy case for repeal of any of the existing legislative overrides, or any discussion of the policy case for the addition of other overrides, such as a character conversion rule that would address the use of long derivative positions in shares to avoid non-resident

\textsuperscript{25} Australia, Income Tax Assessment Act 1936 (herein referred to as “ITAA 1936”), former sections 160APHO-160APHU. As part of a comprehensive rewrite of the Australian income tax legislation, the dividend imputation rules in the ITAA 1936 were repealed and incorporated in the Income Tax Assessment Act 1997 (herein referred to as “ITAA 1997”). The anti-dividend-credit-trading rules were not, however, incorporated in the ITAA 1997. Instead, section 207-145 of the ITAA 1997 provides that taxpayers are not entitled to dividend credit relief unless they are within the definition of a “qualified person” under division 1A of former part IIIA of the ITAA 1936 (hold period requirement and related payment rules). The use of delta for the purposes of the Australian rules is discussed in detail in the text below, at note 198 and following.

\textsuperscript{26} IRC section 871(m) and prop. Treas. reg. section 1.871-15, REG-120282-10, 2013-52 IRB 837. The proposed regulations are issued under the rule-making authority to (1) specify when a notional principal contract (NPC) “is of a type which does not have the potential for tax avoidance” (IRC section 871(m)(3)(B)); and (2) specify other payments as dividend equivalents because they are substantially similar to specified NPC payments and substitute payments under SLAs (IRC section 871(m)(2)(C)). For a detailed discussion of the use of delta as a measure of risk exposure under the US rules, see the text below at note 198 and following.
withholding tax generally.\textsuperscript{27} In short, the existing set of risk-based overrides in the Act that is intended to address discrete avoidance transactions is taken as a given; that being the case, the suggested legislative template could be used in specifying risk exposure for the purpose of any other similar overrides that might be adopted.

The discussion that follows is divided into five parts. Part one provides some necessary background and is broadly descriptive of current law governing the assignment of tax attributes associated with shares. The possible policy rationale for the legislative pattern is discussed, along with the rationale for the use of detailed rules rather than standards in legislatively overriding the core assignment principle based on share ownership. There is also some discussion of certain general types of legislative overrides, which include risk-based anti-avoidance rules for hedged and derivative positions in shares, and possible reasons for differences between these types based on the nature of the tax attribute to be assigned. Parts two, three, and four articulate the details of a legislative template that could be used in the specification of the set of risk-based anti-avoidance rules in the Act that override share ownership in the assignment of tax attributes. The discussion in each of these parts explores the three claims noted above regarding desirable design features. Part five provides concluding comments.

**LEGISLATIVE PATTERN ASSIGNING TAX ATTRIBUTES TO POSITIONS IN SHARES**

The term “tax attributes,” as used in this article, applies to features or characteristics of property that have income tax consequences, including liability to tax on income or gain, the availability of expense or loss recognition, and the timing of the recognition of these same amounts.\textsuperscript{28} In the context of US income tax law, Thompson and Weisbach describe the legislative pattern assigning tax attributes of shares as well as securities more generally.\textsuperscript{29} They characterize US law as assigning tax attributes on the basis of ownership as a matter of private law, subject to the application of targeted legislative overrides as well as an indeterminate judicial overlay. This same

\textsuperscript{27} See generally, Edgar, supra note 7, at 359-61. The need for a character conversion rule addressing the use of long derivative positions in shares to avoid non-resident withholding tax was the subject of considerable debate in the United States before the enactment of IRC section 871(m). See, in this respect, United States Senate Committee on Homeland Security and Governmental Affairs, Permanent Subcommittee on Investigations, Staff Report, *Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends*, 110th Cong., 2d sess. (Washington, DC: Permanent Subcommittee on Investigations, September 2008). With the enactment of IRC section 871(m), this avoidance business has migrated to the London-based operations of many US financial institutions where long derivative positions in shares are used to avoid non-resident withholding taxes in those countries without a comparable character conversion rule. See Jenny Strasburg, “Fed Questions Bank Maneuver To Reduce Hedge Funds’ Dividend Taxes,” *Wall Street Journal*, September 29, 2014.

\textsuperscript{28} See Thompson and Weisbach, supra note 18, at 250 (defining “tax attributes” as “the rules that govern deviations from a pure Haig-Simons base”).

\textsuperscript{29} Ibid., at 254-69.
pattern is broadly characteristic of Canadian income tax law, but in contrast to US courts, Canadian courts have been much less willing to articulate an inquiry into ownership that deviates significantly from the private-law concept.

In a tax-avoidance context, legislative overrides of ownership in the Act focus on transactions that can be seen to manipulate the private-law concept to assign, or to avoid the assignment of, tax attributes. Although they are associated with distinct transactional fact patterns and different tax attributes, the legislative overrides have two general design features in common: (1) identification of prohibited transactions primarily without requiring an inquiry into taxpayer purpose, and (2) legislative expression in the form of detailed rules rather than a generally expressed standard. As a subset of legislative overrides, risk-based rules can be seen to use risk exposure, either explicitly or implicitly, as a proxy for taxpayer purpose.

Assignment of Tax Attributes Based on Share Ownership and the Policy Significance of Risk

Shares have a number of attributes that are tax attributes in the sense that they are relevant to the determination of the income tax consequences of holding shares or otherwise transacting in shares. For example, dividend distributions are taxable with relief for corporate income tax assumed to be paid on the underlying income. For resident individuals, the relief takes the form of the dividend gross-up and credit mechanism, while an offsetting taxable income deduction is provided for taxable Canadian corporations. For non-residents, part XIII withholding tax (reduced by treaty where applicable) applies to dividends paid by Canadian-resident corporations. “Adjusted cost base” and “proceeds of disposition” determine capital gain or loss realized on a “disposition” of property, including shares. “Paid-up capital” determines the character of distributions on certain transactions in shares as dividends rather than a distribution of capital or a realized capital gain or loss. Because of the judicial interpretation of the concept of corporate control, voting power is relevant for a range of purposes, including the status of two or more corporations as “associated

30 Paragraphs 82(1)(a) and (b) and section 121.
31 Subsection 112(1).
32 Subsection 212(2).
33 Section 54, definition of “adjusted cost base.”
34 Section 54, definition of “proceeds of disposition.”
35 Subsection 248(1), definition of “disposition.”
36 Paragraphs 40(1)(a) and (b).
37 Subsection 89(1), definition of “paid up capital.”
38 But see Robert Couzin, “Some Reflections on Corporate Control” (2005) 53:2 Canadian Tax Journal 305-32 (arguing that the concept of “control” articulated in the case law as residing in ownership of shares with a majority of the votes in an election of the board of directors—referred to as de jure control—remains uncertain in a range of fact patterns).
corporations,”39 “related corporations,”40 or “affiliated corporations,”41 as well as the status of a non-resident corporation as a “controlled foreign affiliate”42 and a resident closely held corporation as a “Canadian-controlled private corporation.”43 The income tax consequences that follow on an acquisition of corporate control44 similarly turn on the location of shareholder voting power. Other provisions, such as status as a “specified non-resident” for the purpose of the thin capitalization rules,45 “connected” corporate status for part IV tax purposes,46 and a “substantial interest” for the purpose of part VI.1 tax on dividends on taxable preferred shares,47 depend (in part) on the status of shares as voting shares.

In the first instance, these various tax attributes are assigned to the taxpayer who owns or disposes of the shares as a matter of private law. Although this is admittedly an oversimplification, the approach to the characterization of share ownership under the Act has been, for the most part, formalistic, with the registered owner (or in the case of certificated securities, the holder) being treated as the owner for income tax purposes.48 The fact that the definition of a disposition is inclusive only, with the relevant jurisprudence supporting a broad interpretation that extends beyond a sale, has not led Canadian courts and the Canada Revenue Agency (CRA) to undertake any sort of wide-ranging assessment of the risk and return characteristics of a particular arrangement and to articulate a concept of share ownership that is unique to the tax law.49 In the absence of specific legislation, this approach has been

39 Subsection 256(1).
40 Paragraph 251(2)(c). The concept of corporate control is also relevant in determining when a person and a corporation are related: paragraph 251(2)(b).
41 Paragraph 251.1(1)(c). The concept of corporate control is also relevant in determining when a person and a corporation are affiliated: paragraph 251.1(1)(b).
42 Subsection 95(1), definition of “controlled foreign affiliate.”
43 Subsection 125(7), definition of “Canadian-controlled private corporation.”
44 Subsections 111(4) through (5.5). See also subsection 67(11), paragraph 87(2.1)(b), subsection 110.1(12), and subsection 111(12).
45 Subsection 185(5), definitions of “specified shareholder” and “specified non-resident shareholder.”
46 Paragraph 186(4)(b).
47 Subsection 191(2). See also paragraph 187.1(b), definition of “excepted dividend” for the purpose of part IV.1 tax payable in respect of taxable dividends received on taxable preferred shares.
48 A formalistic approach to the concept of share ownership is apparent, for example, in the characterization of SLAs in the absence of section 260 and of “repo” financing transactions. See, for example, Jonathan W. Wilson, “Securities Lending: An Overview and Update for Domestic and Cross-Border Transactions,” in the 2009 Conference Report, supra note 8, 9:1-36, at 9:5-6, reviewing the disposition issue, including relevant statements of the Canada Revenue Agency’s (CRA’s) administrative position, with respect to SLAs and repos.
49 See, for example, Wortsman et al., supra note 8, at 8:20 (“There is no discernible policy suggesting that a taxpayer should be considered to have realized capital gains on a property solely because the taxpayer has transferred some of the economic risk in respect of the property”). But see Hayward, supra note 9, at 1791-96 (arguing that the non-exhaustive definition of a
maintained even though case law in the context of non-financial assets suggests that it is an amalgam of title, possession, use, and risk that constitutes ownership for income tax purposes.\(^{50}\) Moreover, a transfer of title (or a transfer of possession in the case of securities held in certificated form) has been accepted as the occasion supporting characterization as a disposition.\(^{51}\) This approach has been qualified in some limited instances in which a change in the legal rights associated with shares, as well as debt instruments, is considered to result in a disposition\(^{52}\) or share value is shifted and effectively transferred between taxpayers.\(^{53}\) Although a concept of beneficial ownership, in apparent contrast to legal ownership, is considered relevant to the determination of ownership for income tax purposes, its content remains unclear. With the possible exception of its use in certain tax treaty articles,\(^{54}\) the concept has arguably not been invoked as the basis for a specification of ownership that is unique to the tax system, requiring an inquiry into perceptions of economic substance entirely independent of any private-law meaning.\(^{55}\)

As described by Thompson and Weisbach, reliance on the private-law concept of ownership as the basis for the assignment of tax attributes is similarly characteristic of US income tax law.\(^{56}\) They explore in some detail the private-law concept in the context of publicly traded securities that are held indirectly through brokers, clearinghouses, custodians, and nominees,\(^{57}\) and propose that ownership for US income tax purposes should coincide with a security entitlement in the case of publicly traded securities held indirectly.\(^{58}\) In the case of shares held directly, they disposition and the acceptance by Canadian courts that the concept can be given a broad interpretation mean, in principle at least, that equity monetization transactions could be treated as dispositions independent of the private-law characterization).

\(^{50}\) See Wortsman et al., supra note 8, at 8:9-11 (reviewing case law and CRA statements of administrative practice regarding the incidents of ownership and its transfer sufficient to attract disposition treatment). See also Hayward, supra note 9, at 1791-96.

\(^{51}\) See Wortsman et al., supra note 8, at 8:9-10.


\(^{53}\) The case law is not entirely clear on the disposition issue. See, for example, The Queen v. Kieboom, 92 DTC 6382 (FCA) (no disposition without a transfer but possible taxation as a benefit conferred on the new shareholder).

\(^{54}\) See Velcro Canada Inc. v. The Queen, 2012 TCC 57; and Canada v. Prévost Car Inc., 2009 FCA 57 (considering the meaning of beneficial ownership in the tax treaty context).


\(^{56}\) Thompson and Weisbach, supra note 18, at 254-69.

\(^{57}\) Ibid., at 281-84.

\(^{58}\) Ibid., at 284.
conclude that ownership should follow current US law and be equated with title.59 Thompson and Weisbach suggest, however, that ownership functions as what they refer to as a “default rule” for the assignment of tax characteristics or attributes to positions in securities.60 They argue that reliance on the private-law concept of ownership as the default rule for assigning tax attributes to shares is desirable because it provides a simple basis for doing so, it “gets the assignment correct for the overwhelming majority of cases,”61 and therefore, for the vast majority of cases, it minimizes the costs of assigning attributes without loss of correctness.62 For those cases in which the default rule is seen to realize an inappropriate assignment, Thompson and Weisbach prefer the use of legislative overrides that can be tailored to particular transactions in light of the underlying rationale for the relevant tax attributes.63 They emphasize that legislative overrides operate most clearly and effectively where they do so on the basis of a “known-background rule”;64 and they critique the decisions in *Anschutz Co. v. Commissioner*65 and *Calloway v. Commissioner*66 for the confusion that these decisions create by approaching the assignment of tax attributes using a concept of ownership that is modified for income tax purposes by an indeterminate “substance-over-form” or “benefits and burdens” analysis, in an attempt to address the separation of ownership as a matter of private law and the associated economics of the positions in shares implemented by the taxpayers in these cases.67

Although Thompson and Weisbach assert that reliance on the private-law concept of share ownership gets the assignment of tax attributes correct for the vast majority of cases, they do not suggest what criterion or criteria they have in mind for the assessment of the correctness or incorrectness of their proposed default rule.

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59 Ibid., at 284. Where shares are held in registered form, title would reside with the registered owner. Where shares are held in certificated form, title would reside with the bearer.

60 Ibid., at 251.

61 Ibid., at 281. See also Edward D. Kleinbard, “Risky and Riskless Positions in Securities” (1993) 71:12 *Taxes: The Tax Magazine* 783-99; and Alex Raskolnikov, “Contextual Analysis of Tax Ownership” (2005) 85:2 *Boston University Law Review* 431-516 (emphasizing the role of the concept of share ownership for private-law purposes as determinative of share ownership for US income tax purposes). Thompson and Weisbach, supra note 18, at 281, acknowledge that their proposed approach is similar to that of Kleinbard and Raskolnikov but “with the strong emphasis not found in those articles, that ownership is just a default rule for assigning attributes.”

62 Thompson and Weisbach, supra note 18, at 281.

63 Ibid.

64 Ibid.

65 135 TC 78 (2010); aff’d. 644 F.3d 313 (10th Cir. 2011).

66 135 TC 26 (2010).

67 Thompson and Weisbach, supra note 18, at 269-80 (also discussing the decision in *Samueli v. Commissioner*, 132 TC 37 (2009), particularly with respect to its strained interpretation of the assignment of tax attributes under the securities lending rules in IRC section 1058 rather than the application of a judicially articulated override of the private-law concept of ownership in the assignment of tax attributes).
Their unstated assumption may be that reliance on the private-law concept of share ownership to assign tax attributes is somehow correct because the owner bears all risk of loss and opportunity for gain or profit.68 The correctness of such an assumption is not, however, obvious on its face and requires some unpacking. Descriptively at least, the legislative concept of a disposition—and, by implication, the concept of ownership—can be seen to be based on three assumptions centred on risk: first, that the essence of a disposition is the transfer of risk associated with an asset; second, that transfer of the ownership of an asset as a matter of private law is an accurate proxy for changes in risk; and third, that changes in risk appropriately signal a change in the assignment of tax attributes associated with share ownership.69 In fact, as Thompson and Weisbach emphasize, ownership has no income-measurement role to play under an ideal income tax that brings into account unrealized gains and losses annually on an accrual basis. Once an income tax system moves away from that ideal to a realization-based approach for apparent practical reasons, such as liquidity and valuation concerns, there are no obvious principles that suggest an appropriate boundary between a disposition transaction and the retention of ownership. Instead of an assessment of risk unique to the tax law as the basis for the application of this tax distinction, the private-law concept of ownership is accepted as a proxy. Hedged and derivative positions in shares challenge this reliance on the private law as an accurate proxy and lead to responses based on perceptions of risk associated with offsetting long and short positions in an asset.70

Yet these observations only invite the normative question: “Why should risk have any significance in the assignment of tax attributes?” Risk is a measure of the variability of cash flows that, in turn, affect the pricing and value of financial and non-financial assets. It is suggested here that the normative significance of risk—with both a reliance on ownership as a matter of private law as the basic principle for the assignment of tax attributes and the adoption of risk-based legislative overrides of the core principle—is its use as a proxy for taxpayer purpose in the identification of tax-avoidance transactions.71 Risk exposure may defensibly be used as a proxy if

68 See, in this respect, 2015 Budget Plan, supra note 3, at 463 (“From a tax policy perspective, a case can be made that a shareholder should always be required to bear the risk of loss and enjoy the opportunity for gain or profit on a Canadian share in order to take advantage of the inter-corporate dividend deduction on dividends received on that share”).

69 See, for example, Daniel Shaviro, “Risk-Based Rules and the Taxation of Capital Income” (1995) 50:4 Tax Law Review 643-724 (arguing that the source of different tax treatments and associated avoidance opportunities is a reliance on perceptions regarding risk and the identification of differences in legal rights and obligations as accurate indicators of changes in risk).

70 See Kleinbard, supra note 61, at 786-87 (noting that the fungibility of publicly traded securities means that there can be many long and short positions but only one owner).

71 Edgar, supra note 7, at 348-51. See also, for example, the preamble to prop. Treas. reg. section 1.871-15, supra note 26, at 841 (“When dividends paid on physical securities are subject to tax while dividend equivalents with respect to economically comparable derivatives are not, those derivatives have a potential for tax avoidance regardless of whether a long party is using the derivative in a particular case to avoid tax. Accordingly, the Treasury Department and the
it is considered intolerably costly, in terms of both compliance and administrative burden, to inquire directly into a taxpayer’s purpose with respect to a position in shares, given the frequency of hedged and derivative positions. As a proxy, risk exposure is assumed to be an accurate indicator of purpose that can be observed at a tolerable cost. As an initial proposition, the taxpayer who owns shares as a matter of private law is assigned the associated tax attributes because it is assumed that the taxpayer bears all risk exposure, and this assumption supports the conclusion that non-tax factors drive the decision to retain the shares or dispose of them. Risk-based rules override this basic assignment principle, because it is suspected that a range of hedge and derivative strategies are driven by the attempt to separate risk and ownership in order either to assign tax attributes to a taxpayer other than the owner or to retain ownership without attracting a disposition for income tax purposes.72

In the use of a proxy for taxpayer purpose, the set of risk-based rules in the Act is, in fact, part of a family of specific anti-avoidance rules overriding share ownership as the basis for the assignment of tax attributes. This family of overrides is required because an unqualified reliance on the private-law concept of ownership as the basis for the assignment of tax attributes is readily open to manipulation. The general transactional pattern of the relevant tax-planning techniques is familiar to tax practitioners, policy makers, and tax administrators. Moreover, implementing any of these arrangements is relatively costless, and it is therefore unsurprising that specific legislative responses are used to override the assignment of tax attributes that would otherwise follow ownership based on the private-law concept. It is also unsurprising that these legislative overrides have developed on a piecemeal basis in response to particular transactions that are seen to be tax-driven in the sense of a perceived manipulation of ownership as the basis for the assignment of tax attributes. In addition to the series of risk-based rules, which override ownership to assign or deny the availability of a tax attribute on the basis of perceptions of exposure to risk,73 other examples of overrides affecting share ownership include

- the anti-income-splitting rules that apply to certain transfers of property, to assign income from the property to the taxpayer who transferred it to the owner;74

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IRS [Internal Revenue Service] favor a delta approach that objectively identifies transactions in which the long party is able to sufficiently approximate the economic return associated with an underlying security).

72 See, for example, the preamble to prop. Treas. reg. section 1.871-15, ibid., at 842 (suggesting that a long derivative position in shares with a delta of 0.7 or greater sufficiently approximates the economic returns associated with ownership of shares to be subject to non-resident withholding tax on cross-border dividend equivalent payments).

73 See the discussion below under the heading “Specifying Risk Exposure Differently for Different Overrides.”

74 Sections 74.1 through 74.5. See also subsections 56(2) and (4) through (5), and sections 75 and 120.4.
the constructive share ownership rules that assign voting power to a taxpayer other than the owner;  
the anti-surplus-stripping rules that override the paid-up capital result that would otherwise occur on a sale of shares between certain persons that do not deal at arm’s length;  
the back-to-back loan provision in the thin capitalization rules that overrides the interposition of an arm’s-length intermediary.

Thompson and Weisbach do not address the design details of the various legislative overrides in US tax law that are intended to alter the assignment of tax attributes otherwise made on the basis of the private-law concept of ownership as the default rule. They assume that the different policy contexts implicated by these legislative overrides dictate that there will be no commonality in design. As a minimal proposition, their observation regarding the inevitable heterogeneity of legislative overrides is evident in the different fact patterns that are the subject of the categories of such overrides in the Act noted above. As suggested here, however, the set of rules within each category reflects a similar approach to the execution of the identification function in a tax-avoidance context: that is, these rules avoid an inquiry into taxpayer purpose as the primary mechanism for identifying prohibited transactions and instead use proxies for such purpose as refined by limited exclusions for circumstances that can be assumed to be non-tax-driven. This legislative pattern reflects a more generalized policy choice regarding the expression of legislative overrides of ownership as detailed rules rather than standards.

Form of Legislative Overrides: Rules Versus Standards

The DFA and the SDA legislation, as well as the SEA proposals, reflect a rules-based approach characteristic of specific anti-avoidance rules. As Finance appeared to suggest in the 2013 budget and again in the 2015 budget, reliance on the standard...
expressed in GAAR could, in principle at least, realize the same result. In fact, the rationale for the choice to use a detailed rule rather than a generalized standard to override ownership in the assignment of disposition treatment, gain/loss characterization, and the provision of dividend tax relief may be found in the wider debate in the legal literature over the choice of rules versus standards as expressions of the law. Although the arguments emphasized in this broader debate are not articulated in any detail in the 2013 and 2015 budgets, they arguably underlie Finance’s stated preference for the adoption of the DFA and SDA legislation and the SEA proposals consistent with the use of targeted risk-based and other legislative overrides of ownership to assign particular tax attributes.

A rules-based approach to the articulation of the content of the law attempts to specify in advance the legal consequences of behaviour or transactions; it is an approach to law that tries “to make most or nearly all legal judgments under the governing legal provision in advance of actual cases.” A standards-based approach involves the expression of a broad principle, with the legal consequences of behaviour or transactions being determined after the fact; it leaves the resolution of legal consequences to an ad hoc, case-by-case analysis that is based on the application of the broad principle or principles. As Kaplow argues, detailed legislative rules are the preferred means, from an efficiency perspective, to describe the legal consequences of such transactions, because the one-time promulgation costs are likely to be less than the costs associated with the process of defining, after the fact, the details of the application of broad standards to a range of such transactions. And as Gergen notes, standards are to be preferred over detailed rules as an effective means to address areas of the law that are in a “state of flux” since, in these circumstances, legislators do not have sufficient foresight to anticipate all conceivable cases that must be addressed by the system of rules. Unanticipated transactions are

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81 2013 Budget Plan, supra note 1, at 341 and 343.
83 Kaplow, supra note 80.
84 Gergen, supra note 82, at 856-57.
more efficiently addressed ex post as they arise, with their resolution being an outcome of reasoning by analogy to the supposed paradigm transactions that can be described in general principles-based legislation.86

The wider debate in the legal literature over the choice of rules or standards as expressions of the content of the law is reflected in a longstanding theme in the tax literature concerning the form of legislation as detailed rules or general principles. In this literature, tax law is often criticized for an overemphasis on rules and the attendant compliance and administrative costs. By comparison, the expression of tax legislation in the form of general principles tends to be seen favourably,87 with desirable simplicity features that reduce compliance and administrative costs. This tax literature often misses the point, however, in the choice between rules and standards, which is not a choice over the content of the tax law but rather a choice regarding the process for the articulation of the content of the tax law.88 Where legislation is expressed at a level of general principle, the detailed content of the law must be worked out either in specific regulations or through administrative practice and the decisions of the courts. The use of detailed legislation or general principles is ultimately a debate over matters of process, which involves a judgment regarding the relative advantages and disadvantages of an apparent certainty of application and complexity of expression associated with the former approach and the apparent simplicity of expression and uncertainty of application associated with the latter approach.

Where a range of common transactions are affected, the expression of the tax law as a standard is costly for two principal reasons that are attributable to the required articulation of the transactional content of the tax law ex post.89 First, the judicial process does not lend itself easily to the efficient resolution of a large volume of specific cases. In particular, it takes considerable time for an issue to work its

86 See, in this respect, Alice G. Abreu and Richard K. Greenstein, “The Rule of Law as a Law of Standards: Interpreting the Internal Revenue Code,” Duke Law Journal Online (forthcoming) (arguing that the dominance of a rules-based expression of the tax law does not require an approach to interpretation of all provisions as rules, and that many IRC provisions should be interpreted as standards to allow the IRS and the courts sufficient flexibility to respond to “unforeseen cases as they arise”).


88 Kaplow, supra note 80 (emphasizing that the content of the law remains the same, with the important policy choice being centred on matters of process—that is, whether to use detailed legislative rules that determine legal results ex ante or to use general standards that require a determination of the details of the law after actions are taken).

89 See, for example, Wei Cui, “Taxing Indirect Transfers: Improving an Instrument for Stemming Tax and Legal Base Erosion” (2014) 33:4 Virginia Tax Review 653-700, at 672-81 (discussing the use of a rules-based versus a standards-based response to ensure source-country taxation of capital gains realized by non-residents through indirect share transfers).
way through the audit, assessment, and appeals processes, which must be followed before reaching formalistic and time-consuming court procedures. Without some adjustment of these aspects of dispute resolution, it is costly to rely on the courts for the development of a framework that can be designed to address the relevant policy issues. In the absence of detailed rules, the judicial process would likely have to be supplemented, in practice, with an even greater reliance on administrative rulings and the judgment of tax practitioners to resolve specific cases in a timely manner. A second source of costliness of application is expectations of judicial performance, particularly where the range of common transactions involves tax-avoidance transactions. The past performance of the courts in Canada (and many other countries) makes it difficult to have confidence in the judicial ability to produce consistent results. The source of much of this inconsistency, at least in an avoidance context, is the factual determination of taxpayer purpose where a purpose-based standard is specified to identify prohibited transactions. The inconsistency is compounded where the standard also involves an inquiry into legislative purpose as an overlay of taxpayer purpose such as that found in subsection 245(4). The focus on statutory interpretation as an identification tool has arguably made GAAR underinclusive (or at least somewhat inconsistent in its application). The underinclusiveness (or inconsistency of application) arises because of the perception that there is a range of acceptable tax-avoidance behaviour (other than that expressly provided for in tax-expenditure programs), and this behaviour can be identified by examining the wording of the relevant legislation. Although unclear, this premise may be the reason why Canadian courts, in particular, are inclined to determine tax consequences on the basis of private-law relationships irrespective of perceptions of the associated economic substance, with the frequent result that particular rules trump the expression of an anti-avoidance provision in the form of a standard. Given this judicial environment, it is not especially difficult to see why Finance would prefer enactment of specific legislation targeted to common transactions when the range of such transactions includes tax-driven and non-tax-driven transactions that must be distinguished in order to apply suitably different tax consequences. Under these conditions, there is no reason to wait for lengthy administrative and judicial resolution of matters that can be resolved effectively and immediately through detailed legislation.

90 See Gergen, supra note 82, at 857 (suggesting in the US context that a reliance on the rulings process as the principal resolution mechanism to resolve the treatment of new financial instruments generally would require significant changes, including the use of retroactive rulings and a caveat on all rulings that they are “conditional on an instrument not later exhibiting undesirable properties”).

91 Ibid., at 857-58. See also United States, Government Accountability Office, Financial Derivatives: Disparate Tax Treatment and Information Gaps Create Uncertainty and Potential Abuse, GAO-11-750 (Washington, DC: GAO, September 2011) (herein referred to as “US GAO report”), at 35 (noting that, in the absence of guidance from the IRS, taxpayers may attempt to take positions that may be abusive).
In fact, the structure of GAAR, with its purpose-based inquiry overlaid with an exercise in statutory interpretation, incorporates two general types of costly standards that should be invoked solely as a response to uncommon or unanticipated transactions, the tax treatment of which cannot, by definition, be specified ex ante. One type of standard is comparable to that in the non-tax law; it involves the interpretation and application of general wording to particular fact patterns most often, but not always, in a non-avoidance context. For example, the concepts of residence, employment, and an adventure or concern in the nature of trade are not articulated legislatively in any comprehensive detail, leaving the content of these concepts, with attendant tax consequences, to be determined ex post. The other type of standard is used in a tax-avoidance context characterized by the motivation for a transaction. In identifying prohibited tax-avoidance transactions, that motivation is commonly expressed legislatively as a “purpose requirement”: that is, a potentially prohibited transaction is one that is undertaken primarily to access a tax benefit. Determining the transactional content of the tax law in these instances requires an inquiry into the motivation of a particular transaction; it is characterized by factual uncertainty that is clarified ex post. Costliness of the identification function is associated equally, however, with both of these types of standards, because they both leave the articulation of their transactional content to the tax administration and the courts. An element of costliness may even be unavoidable, since the choice to use rules in the tax law is rarely one that involves a complete rejection of the use of a standard and is probably more accurately framed as a question of the extent to which the latter is incorporated in a rule to most effectively execute the underlying policy decision.

Where the tax consequences for a range of common transactions in a non-avoidance context must be specified, costliness in the application of the tax law is at least mitigated by the expression of the law as detailed rules that describe the relevant set of common transactions and thereby minimize the interpretive exercise in determining the transactional content of the law. In an avoidance context, costliness of the identification of prohibited transactions can be mitigated further if observable proxies for taxpayer purpose can be identified. In other words, proxies must

92 See, in this respect, David A. Weisbach, “Formalism in the Tax Law” (1999) 66:3 University of Chicago Law Review 860-86 (emphasizing that a strictly rules-based system would be more complex and costly than a system that combined rules and standards).


94 See, for example, Canada, Department of Finance, Explanatory Notes Relating to the Income Tax Act, the Excise Tax Act and the Income Tax Regulations (Ottawa: Department of Finance, September 2013), at 62 (stating that the synthetic disposition rules are based on the effects of an arrangement,
be easily observable and credibly accurate for a range of transactions that are common in the sense that they can be anticipated by the policy maker as avoidance techniques. As in the non-avoidance context, the set of anticipated transactions should be specified in as much detail as possible to avoid the interpretive exercise that a more general expression of the tax law requires. Under these conditions, the anti-avoidance rule can ideally be applied ex ante at lower cost and without affecting the set of common transactions that are non-tax-driven.95

It is argued in the next part of the article that a weakness of both the DFA and the SDA legislation, as well as the SEA proposals, is the use of a standard to specify the level of risk exposure that will attract their application. This is a weakness because it means that the legislation suffers from the same problems as a more generalized standard in the tax law; yet the reasons for choosing a standard over a rule do not necessarily support expression of the level of risk exposure as a standard. By providing a wider choice of levels of risk exposure, a more precise specification as a percentage amount expands the potential to more finely distinguish between hedged and derivative positions in shares that can be considered tax-driven and those that can be considered non-tax-driven. This particular proposition can also be extended to other risk-based rules in the Act that override the assignment of tax attributes on the basis of the private-law concept of ownership, with the idea being that the content of these other rules can be expressed with much more commonality in an effort to realize a greater level of target-effectiveness at tolerable compliance and administrative cost.

**SPECIFICATION OF RISK EXPOSURE**

This part of the article, together with the next two parts, articulates a legislative template for specific anti-avoidance rules that are risk-based overrides of ownership as the basis for assigning tax attributes to hedged and derivative positions in shares. The legislative template consists of the following three elements:

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95 Recent contentiousness over the form of an anti-treaty-shopping provision as either an inquiry into taxpayer purpose or a US-style limitation-on-benefits (LOB) provision emphasizes these lines of argumentation for a purpose-based standard or a detailed rule with the use of proxies for taxpayer purpose. See Canada, Department of Finance, Treaty Shopping—The Problem and Possible Solutions (Ottawa: Department of Finance, August 2013); and Organisation for Economic Co-operation and Development, BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances (Paris: OECD, 2014).
1. explicit specification as a percentage amount of a level of risk exposure that either attracts the application or avoids the application of the legislative override;
2. use of an explicit purpose-based inquiry to support the application of the legislative override by suppressing discontinuities created by the sharp boundaries attributable to specification of a level of risk exposure; and
3. use of the financial concept of delta to measure the level of risk exposure associated with hedged or derivative positions in shares.

This part of the article considers the first element. The second and third elements are considered in the next two parts, respectively.

The policy maker can tailor each of these three elements to best fit the income tax consequences associated with the assignment of tax attributes, given the assumed policy underlying the attribute. This kind of tailoring is illustrated using the examples of the DFA and SDA legislation, as well as the dividend stop-loss rules, the anti-foreign-tax-credit-trading rule applicable to short-term securities acquisitions, the DRA rules and the SEA proposals, and the wash sale rules in the Act. It is suggested how and why each of these types of rules can defensibly differ in their specification of a level of risk exposure. It should be evident that use of the legislative template, even with tailoring to fit different policy purposes, would result in a much greater level of commonality of legislative design than is currently the case and might realize an element of economies of scale in tax administration and compliance.

Two policy criteria inform an assessment of the design details that implement the above three elements of the suggested legislative template:

1. target-effectiveness in the use of risk as a proxy for a tax-motivated position in shares; and
2. suppression of wasteful and costly discontinuities whereby small changes in risk exposure result in a disproportionately different assignment of a tax attribute.

**Line Drawing and the Legislative Expression of a Level of Risk Exposure**

Specification of a level of risk exposure that attracts or avoids the application of a legislative override of an assignment of tax attributes based on ownership performs a targeting function that is most problematic with long positions in shares that are partially hedged or long derivative positions that partially replicate an open position. At one extreme, there is an unhedged or long position in shares that entails full exposure to risk for the owner. In these circumstances, tax attributes of the shares are assigned on the basis of ownership on the apparent assumption that such exposure precludes any attempt to separate a tax attribute from ownership. At the other extreme is a long position in shares that is fully hedged or a long derivative position that perfectly replicates an unhedged position. In these circumstances, it can be assumed that the hedged position or the long derivative position represents an attempt to
separate a tax attribute from ownership or, alternatively, that the position should be treated consistently with non-ownership or ownership, respectively, because it so closely approximates either of those positions.96 Between the two extremes of unhedged positions and fully hedged, as well as fully exposed, derivative positions are long positions in shares that are partially hedged and long derivative positions that partially replicate an open position in the underlying. Because these partial positions leave the taxpayer partially exposed to the risk associated with an open position, they require a distinction to be drawn between, on the one hand, a tax-driven attempt to manipulate tax-attribute assignment based on ownership and, on the other hand, hedged or derivative positions that are entered into for non-tax reasons.

In the context of hedged and derivative positions in shares, the specification of a level of risk exposure as a proxy for taxpayer purpose targets risk-based overrides of ownership and should ideally have two properties in performing this function:

1. The level of risk exposure should be specified so as to affect only a limited range of positions that can be assumed with some confidence to be tax-motivated. The narrow targeting of legislative overrides can address, at least in part, the problem of revenue loss without imposing unnecessary costs on commercially driven hedging and trading strategies.97 Any other approach that applies beyond instances of substantial risk reduction or replication potentially imposes tax and compliance costs that can undermine the supposed benefits attributable to non-tax-driven risk-reduction and trading strategies. In that case, it becomes difficult to determine whether the revenue concerns associated with the prevention of the tax-driven manipulation of ownership justify the potentially adverse effect on non-tax-driven positions in shares. Moreover, the practical audit difficulty associated with the application of risk-based legislative overrides to a broad range of common transactions is much less problematic when these overrides are limited to transactions involving offsetting positions that eliminate a substantial amount of the risk exposure associated with a long position or that substantially replicate that same risk exposure.

2. The level of risk exposure should be specified as a precise percentage amount rather than by less precise verbal formulas such as “substantially,” “all or

96 See Miller and Milet, supra note 8, at 10:43 (emphasizing consistency of treatment of disposition transactions and hedged positions within the standard under the SDA legislation as providing greater coherence in the taxation of certain financial transactions).

substantially all,” “materially,” “principally,” “primarily,” or “a majority of.”

Provided that the specified percentage is drawn at a level that ensures the limited application of a risk-based override, precise specification as a percentage amount provides a legislative bright line that avoids the costs that taxpayers might otherwise incur to ensure that non-tax-driven partial hedges of, and derivative positions in, shares are unaffected.

As legislative standards, the verbal formulas that are commonly used to specify a level of risk exposure are usually found in a range of provisions other than risk-based legislative overrides of ownership. As a result, administrative practice and judicial interpretation in these other contexts will often have resulted in quantification as a percentage amount. The content of the standards expressed in these verbal formulas is therefore usually well known and will have been converted to a known quantity for the application of risk-based overrides. Nonetheless, an element of imprecision may persist with such verbal formulas, and there will remain some legal uncertainty, at least along the immediate edges of the relevant boundary that they execute legislatively. For some of the less precise verbal formulas, such as “material” or “in a material respect,” the conversion to a percentage amount through the interpretive process may remain ambiguous, with resulting legal uncertainty as to where exactly the boundary lies, rather than just along the immediate edges of a boundary. Resources must then be devoted to the discovery of the boundary between partial hedges and derivative positions that are considered tax-driven manipulation of share ownership and positions that are considered non-tax-driven strategies. This can only be done ex post as particular hedged and derivative positions

98 The explanatory notes to the definition of “derivative forward agreement” in subsection 248(1) use “primarily” as a synonym for the “majority of” standard relevant for sales agreements. Explanatory Notes, supra note 94, at 58.

99 See, for example, Brian R. Carr and Duane R. Milot, “Copthorne: Series of Transactions Revisited,” Corporate Tax Planning feature (2008) 56:1 Canadian Tax Journal 243-68, at 263 (citing case law standing for the proposition that the same term should be given the same meaning under different provisions of the Act). See also Tamara Larre, “Misguided Inferences? The Use of Expressio Unius To Interpret Tax Law” (2014) 51:3 Alberta Law Review 497-524, at 519-23 (reviewing case law in which the failure to use parallel drafting has not led to the inference that different meanings were intended).

100 Miller and Milet, supra note 8, at 10:25-26 (arguing that Canadian courts have adopted a qualitative and contextual approach to the interpretation of an “all or substantially all” standard, but observing that the CRAs administrative position has tended to reduce the standard to a quantitative 90 percent or more bright line, which can be assumed to be incorporated for the purpose of the definition of an SDA, given Finance’s presumed knowledge of that position).

101 See, for example, Wilson, supra note 48, at 9:13 (observing that the threshold standard of “materiality” in paragraph (d) of the definition of “securities lending arrangement” in subsection 260(1), which requires that “the lender’s risk of loss or opportunity for gain or profit with respect to the security is not changed in any material respect,” is undefined, and that counterparties should be careful when entering into non-standard SLAs whereby less than all of the accrued gain or loss is retained by the lender).
challenge that boundary and as it is determined, through administrative practice and ultimately judicial interpretation, where exactly the boundary lies in any particular fact pattern. Perhaps more importantly, taxpayers may forgo, or alter, commercial hedging and trading strategies to avoid the imprecision along the edges of the boundary executed by a verbal formula. In effect, taxpayers may alter their preferred risk exposure simply to ensure that a position is outside a particular legislative override, with resulting non-tax costs in the form of a loss of preferred exposure.

A precise specification of a level of risk exposure avoids these potentially adverse consequences of legal uncertainty and also allows for different, and more nuanced, tailoring of different risk-based overrides of ownership as the basis for the assignment of tax attributes. Use of any of the limited set of familiar verbal formulas to specify a level of risk exposure under a risk-based override of ownership means that the boundary between partially exposed positions that are tax-driven and those that are non-tax-driven is drawn at one of the limited set of possibilities that the interpretive process has provided in other legislative contexts using the standard verbal formulas. For example, “substantially” or “all or substantially all” have tended to be equated with a quantity of 90 percent or more.102 “Principally,” “primarily,” and “majority” have tended to be equated with a quantity in excess of 50 percent.103 Specification of a level of risk exposure using these verbal formulas thus limits the choice of boundary between tax-driven and non-tax-driven positions in shares to two possibilities: (1) risk exposures of 90 percent or more and risk exposures of less than 90 percent; and (2) risk exposures in excess of 50 percent or risk exposures of 50 percent or less. Any specification between these two levels, with a boundary somewhere between 90 percent and 50 percent, is ruled out by the interpretive process in other legislative contexts using the same verbal formulas. The content of alternative verbal formulas, such as “material” or “material respect,” may remain ambiguous and suggestive of anything between, for example, 50 percent and 90 percent and even well below 50 percent.104 Given its ambiguous content, this alternative may be rejected

102 See Miller and Milet, supra note 8, at 10:25-26.
103 See, for example, Miller and Milet, ibid., at 10:8 (stating that “majority” is generally assumed to mean more than 50 percent). See also Richard Marcovitz and Chris Van Loan, "Amendments to the Rules Governing Securities Held by Financial Institutions and Other Recent Developments," in the 2009 Conference Report, supra note 8, 10:1-40, at 10:11 (noting that the CRA has taken the administrative position that “primarily” means more than 50 percent, and this meaning presumably extends to the definition of “tracking property” subject to mark-to-market treatment for a financial institution where the particular property derives its value primarily from underlying property that would be subject to mark-to-market recognition if held directly).
104 Apparently, any agreement that the shares are to be transferred back by the recipient at their value at the time of the initial transfer is regarded as a sufficient indication of risk retention by someone else. See Canada, Department of Finance, “Draft Legislation Concerning Securities Lending and Dividend Rental Arrangements Released,” News Release no. 89-042, April 26, 1989 and accompanying “Securities Lending: Explanatory Notes.” See also CRA document no. 9511155, October 18, 1995.
because of the potentially adverse effect on non-tax-driven positions in shares. If the policy maker decides that a point somewhere in between 50 percent and 90 percent would, in fact, draw the boundary between tax-driven and non-tax-driven positions in the most target-effective manner for the assignment of a particular tax attribute, the most cost-effective means to implement this policy choice is by specifying the level of risk exposure as a percentage amount.

In assigning tax attributes, risk-based overrides of share ownership elevate risk exposure to an independent normative significance that, in fact, determines the point at which significantly different tax treatment occurs. Yet as a proxy for a tax-avoidance purpose motivating a position in shares, there is no obvious point at which a boundary should be drawn in the absence of systematic empirical evidence. Drawing the line relatively tightly to require a substantial reduction or assumption of risk exposure as a condition of application for a risk-based override attempts to avoid any adverse effect on commercially driven hedging and trading strategies, but this policy prescription is somewhat coarse-grained and does not suggest in any obvious manner where exactly a boundary should be drawn. Indeed, the lack of any obvious point at which risk exposure serves as an accurate proxy for taxpayer purpose means that the line-drawing exercise with risk-based overrides suffers from an inevitable element of arbitrariness, even where a more precise specification of risk exposure is otherwise desirable because the policy maker has some rough empirical confidence that verbal formulas are intolerably overinclusive or underinclusive. For example, there does not appear to be anything normatively compelling that would suggest drawing a boundary at a level of risk exposure of 90 percent versus 95 percent or, alternatively, 90 percent versus 85 percent, let alone deciding between 1 or 2 percentage point differences in such specification. On the other hand, an element of arbitrariness at this level is arguably not a sufficient reason to reject a precise specification of risk exposure as a percentage amount where an alternative verbal formula leaves a wider range of tax-driven positions unaffected or affects a wide range of non-tax-driven positions. Under these circumstances, the policy maker may defensibly specify a level of risk exposure somewhere between the two coarse-grained alternatives provided by the verbal formulas on offer to improve the targeting of a risk-based override in a broad directional sense, even though the choice, at the margin, will have an inevitable arbitrariness.

**Specifying Risk Exposure Differently for Different Overrides**

The legislative overrides of ownership in the Act affecting the assignment of tax attributes to hedged and derivative positions in shares are somewhat eclectic in their design details. Most importantly for the purpose of this article, they do not all incorporate risk exposure explicitly as a proxy for targeted tax-avoidance transactions, and even where they do so, they differ in how that proxy is specified.105 It is suggested  

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below that these risk-based legislative overrides of ownership may be designed with broadly similar patterns in the specification of levels of risk exposure, although they can also be tailored differently in their targeting. What follows are some suggested specifications of risk exposure; they are not offered as hard policy prescriptions but rather as illustrative possibilities of the direction in which targeting might be improved by precisely specifying a level of risk exposure as a percentage amount for some of the different categories of legislative overrides in the Act. The illustrative specifications also highlight why the specified level of risk exposure might be different for the different overrides, and how those overrides would differ from their existing legislative form in the Act.

**Synthetic Dispositions**

The SDA legislation is explicitly risk-based through the definition of a “synthetic disposition arrangement,” which requires the elimination of all or substantially all of the taxpayer’s risk of loss and opportunity for gain or profit in respect of a particular property.\(^{106}\) In the expression of a level of risk reduction that is substantial, the legislation is broadly consistent with the US constructive sale rule\(^ {107}\) and the comparable anti-synthetic rule proposed in Australia.\(^ {108}\) This level of risk reduction is strongly suggestive of a tax-avoidance motivation for a hedged position in an appreciated asset and is deemed to constitute a disposition. In other words, risk reduction of this level is unlikely to be undertaken primarily for non-tax reasons,

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106 Paragraph (b), definition of “synthetic disposition arrangement” in subsection 248(1).

107 IRC section 1259. Under the original legislative proposal, a constructive sale was defined generally as any transaction that “substantially eliminates the risk of loss and opportunity for gain” on appreciated shares, debt, or a partnership interest held by a taxpayer. This general definition was replaced in the final legislation with a set of four enumerated transactions consisting of a long position in an appreciated asset and an offsetting position or positions. See the discussion in the text below at notes 168-178.

108 ITAA 1997, proposed section 230-348C(1) (defining “effective disposal arrangements” as one or more arrangements that have the effect of (1) transferring to another person, or relieving the taxpayer of, the risk of all or a substantial proportion of the negative aspects of the subject rights and/or obligations; and (2) transferring to another person, or depriving the taxpayer of, the opportunity to obtain the benefit of all or a substantial proportion of the positive aspects of the subject rights and/or obligations). ITAA 1997, proposed section 230-348A (providing that the object of subdivision 230-J is to minimize tax deferral and arbitrage that would otherwise occur through arrangements that would allow circumstances to be brought into existence that would have substantially the same effect as, but do not take the form of, circumstances that give rise to assessable gains from financial arrangements).
and it can be seen to serve as a credibly accurate proxy for a tax-avoidance purpose in the vast majority of cases; alternatively, even if non-tax-motivated, risk reduction to this extent can be considered sufficiently close to a disposition in its non-tax features that it should be treated consistently with a transaction that is considered to be a disposition under accepted notions of ownership.

By limiting the application of a risk-based override to a narrow range of partially hedged positions in shares, an “all or substantially all” standard is, nonetheless, potentially underinclusive. An uncertain range of partial hedges providing risk reduction that is significant, but not necessarily within the standard of “all or substantially all,” are unaffected, even though a not insignificant number of these hedged positions may be tax-driven. The policy maker could use a more nuanced approach to specification of the level of risk exposure than a coarse-grained “all or substantially all” standard to address potential underinclusiveness while still avoiding problems of overinclusiveness. In particular, a problematic range of partial hedges could be isolated by providing taxpayers with a safe harbour beginning at a lower bound of risk reduction. Only risk-reduction levels below this lower bound would categorically avoid disposition treatment, on the assumption that the vast majority of partial hedges at these lower levels can credibly be considered non-tax-driven and should be unaffected. In this respect, some illustrative guidance may be found in the Australian anti-dividend-credit-trading legislation, which draws the boundary between tax-driven and non-tax-driven hedges at a risk-reduction level of 70 percent.109 Although designed for the purpose of assigning a different tax attribute, this 70 percent specification could be incorporated under a synthetic disposition rule to provide that partial hedges reducing risk exposure by 70 percent or less would not attract treatment as a disposition for what would seem to be the same rationale: it may be the case that a broad range of partial hedges at this level of risk reduction are undertaken primarily for non-tax reasons and should be unaffected by these different risk-based overrides.

With synthetic dispositions, a problematic range of partial hedges could also be defined as those that reduce risk exposure in an amount greater than 70 percent and less than 90 percent, assuming that partial hedges reducing risk exposure by 90 percent or more should categorically be subject to disposition treatment. A not insubstantial number of partial hedges reducing risk exposure to shares within this problematic band may be motivated by tax considerations; yet, there may be a not insubstantial number of such hedges within the same band of risk reduction that might be undertaken primarily for non-tax reasons. Partially hedged positions in shares within this problematic range could be sorted into tax-driven and non-tax-driven characterizations by an inquiry into taxpayer purpose. The inquiry could be unspecified in terms of what factors are considered relevant, or it could be directed by the policy maker through the creation of a rebuttable presumption that a partially

109 See infra notes 203-207 and the accompanying text.
hedged position within the problematic range is either tax-driven or non-tax-driven. With the former, relevant evidence would be required to rebut the presumption and recharacterize the hedge as non-tax-driven; with the latter, relevant evidence would be required to rebut the presumption and recharacterize the transaction as tax-driven. The choice of presumption would be a function of an empirical judgment that the majority of partially hedged positions within the problematic range are tax-driven or are not.

An inquiry into taxpayer purpose as an additional targeting feature of a synthetic disposition rule would increase costliness of application and should probably be tolerated only if the policy maker is confident in an empirical judgment that there is a not insubstantial range of partially hedged positions that otherwise would be mischaracterized using a stand-alone “all or substantially all”—that is, 90 percent or more—risk-reduction requirement. To mitigate the administrative and compliance costliness of the additional identification exercise, the policy maker could indicate legislatively a set of factors that may be considered relevant. The lack of systematic empirical evidence of the motivation for hedged positions within a defined problematic range means, however, that the policy maker must rely on unsatisfactory anecdotal evidence as the basis for this important targeting refinement.

**Dividend Stop-Loss Rules and Foreign Tax Credit Trading**

The dividend stop-loss rules address the familiar avoidance opportunity that arises where a corporate taxpayer acquires shares shortly before or after the dividend date and sells them shortly thereafter. In those circumstances, the amount paid for the shares includes the amount of the declared or expected dividend, and the subsequent receipt of the dividend that compensates the corporate shareholder for a portion of the cost of the shares. Although the dividend effectively represents a recovery of a portion of the cost, a tax benefit arises if the corporate shareholder can claim an intercorporate dividend deduction for the amount of the cost recovery as well as a separate loss on the sale of the shares equal to the amount of the dividend. The anti-foreign-tax-credit-trading rule applicable to short-term acquisitions of

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110 See, for example, in the US context, Mike Farber, “Section 871(m) and Delta: When Should a Dividend Equivalent Be Treated Like a Dividend?” Tax Matters feature (2014) 5:2 *Columbia Journal of Tax Law* 12-14, at 14 (suggesting that the proposed dividend equivalent payment regulations should establish a presumption that a long derivative position with “high-delta exposure to dividend-paying stock” is subject to non-resident withholding tax on dividend equivalent payments, but the presumption could be rebutted “by showing either material transactions costs or that the counterparty does not own the underlying in connection with the transaction”).

111 For example, in the Australian context, ITAA 1997, proposed sections 230-348D(5), 230-348Q(5), and 230-348X(3) (listing factors to be considered in determining taxpayer purpose). See also the anti-treaty-shopping proposal in the 2014 federal budget: Canada, Department of Finance, 2014 Budget, Budget Plan, February 11, 2014, at 351-52.

112 Subsections 112(3) through (5.6).
securities addresses transactions in which foreign tax credits are effectively traded between taxpayers by transferring ownership of shares (or other securities) as the basis for the assignment of credit entitlement. Before the enactment of the SDA legislation, neither of these anti-avoidance rules was explicitly risk-based. Instead, both relied on a required one-year hold period as a proxy for a tax-avoidance purpose, on the apparent assumption that the associated risk exposure credibly indicates a non-tax motivation for an acquisition. This assumption could be based, in turn, on an empirical assumption that the transaction costs of implementing and maintaining a hedge over the hold period in order to separate ownership and economic exposure in a tax-driven context would be prohibitive. With the enactment of the SDA legislation, consequential amendments to the dividend stop-loss rules and the anti-foreign-tax-credit-trading rule incorporate an additional at-risk requirement by excluding from the hold period those days during which a synthetic disposition was in place.

Incorporation of the at-risk standard in the SDA legislation arguably improves the targeting of these anti-avoidance rules, at least to the extent that hedge transaction costs do not in fact constrain entirely all tax-motivated share acquisitions. However, by affecting only a narrow range of partially hedged positions that are likely tax-driven (or are sufficiently close to non-ownership that ownership should be ignored in assigning the relevant tax attributes), the improvement in targeting may be slight. A wide range of partially hedged positions remain unaffected, even though some may credibly be assumed to be associated with share acquisitions intended to generate a loss using the intercorporate dividend deduction or to transfer entitlement to a foreign tax credit. At the other extreme of overinclusiveness, the US legislation comparable to the dividend stop-loss rules denies the intercorporate dividend deduction unless the relevant shares are held “naked” for at least 46 days. More particularly, share ownership for the purposes of the hold period is ignored for any day during which the corporate shareholder (1) has an option to sell (“covered put”), (2) is under a contractual obligation to sell (“covered call”), or (3) has made (and not closed) a short sale of substantially identical shares or securities. The apparent empirical assumption underlying this specification is that any level of risk reduction is tax-driven. The Australian anti-dividend-credit-trading


114 The significance of transaction costs and other non-tax constraints on tax-motivated hedged and derivative positions in shares for the design of risk-based overrides more generally is discussed further in the text below at notes 152-163.

115 Subsections 112(8) and 126(4.5).

116 Hariton, supra note 85, at 813.

117 IRC section 246(c).

118 IRC section 246(c)(1)(A).
rules lie in between the two extreme specifications of the US rule on the one hand and the Canadian dividend stop-loss rules and anti-foreign-tax-credit trading rule on the other, by specifying a level of acceptable risk reduction of 70 percent or less. A comparable compromise specification of a permitted level of risk reduction would obviously expand the application of these two risk-based overrides in the Act. Although this more expansive override for the purpose of the dividend stop-loss rules and the anti-foreign-tax-credit trading rule applicable to short-term securities acquisitions would almost certainly be overinclusive in its characterization of a not insubstantial number of partially hedged positions that may in fact be non-tax-driven, overinclusiveness may be tolerated because the tax consequences of the classification of an expansive range of partial hedges as tax-driven would be mitigated by the hold period requirement. In other words, risk reduction in excess of 70 percent would not necessarily disentitle an owner of shares to dividend tax relief or foreign tax credits but would result in the exclusion of those days during which the relevant position was hedged from satisfaction of the hold period requirement. A synthetic disposition rule, in contrast, would result in the deemed disposition of an appreciated asset. Because of this all-or-nothing tax consequence, an additional inquiry into the motivation of those partial hedges, outside a specified safe-harbour level of risk reduction but less than that which would be categorically considered tax-driven, may warrant the additional administrative and compliance costs associated with an inquiry into taxpayer purpose.

A synthetic disposition rule, in contrast, would result in the deemed disposition of an appreciated asset. Because of this all-or-nothing tax consequence, an additional inquiry into the motivation of those partial hedges, outside a specified safe-harbour level of risk reduction but less than that which would be categorically considered tax-driven, may warrant the additional administrative and compliance costs associated with an inquiry into taxpayer purpose.

Costliness of the same inquiry across the entire range of problematic partially hedged positions may not necessarily be warranted for the purpose of those overrides imposing an at-risk requirement for shareholding purposes. In fact, incorporation of an at-risk requirement for hold period purposes could permit a reduction in the length of the period used as a proxy for tax-driven hedging. Where no such requirement is incorporated, or it is narrowly

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119 As originally introduced, the Australian anti-dividend-credit-trading proposals provided that any reduction of the risk of loss below 70 percent of the value of an exposed long position in the relevant shares would result in tolling of the hold period for the number of days during which this level of risk reduction was exceeded. Following significant criticism emphasizing the adverse effect of the proposals on share-hedging strategies, the Australian Treasury refined the specification of risk exposure to require maintenance of the current minimum net equity exposure (that is, both the opportunity for profit and risk of loss) of 30 percent. See Australia, Department of the Treasury, “Measures To Prevent Trading in Franking Credits,” Treasurer’s Press Release no. 47, May 13, 1997; and “Budget Measures To Prevent Trading in Franking Credits: Outcome of Consultations,” Treasurer’s Press Release no. 89, August 8, 1997.

120 See the discussion in the text above under the heading “Synthetic Dispositions.”

121 See, for example, Australia, Review of Business Taxation, A Tax System Redesigned—More Certain, Equitable and Durable (Canberra: Review of Business Taxation, July 1999), at 227-50 (recommending that the 45-day rule be replaced with a more limited 15-day rule, and that an exemption threshold for small transactions be increased from A$2,000 to A$5,000). The incorporation of an at-risk requirement to enhance the target effectiveness of a hold period requirement as a proxy for taxpayer purpose would not necessarily affect other targeting features, such as the shareholding condition in the dividend stop-loss rules of 5 percent or less of the affected class of shares, which overlay risk exposure.
focused, hold periods may be extended in length as a coarse-grained means to further screen out days during which a position in shares is hedged, but with associated administrative and compliance costs. The policy maker can defensibly trade off expansiveness of an at-risk requirement and the length of a hold period in refining the targeting of the relevant risk-based override, while attempting to keep administrative and compliance costs roughly constant.

**Dividend Rental Arrangements and Synthetic Equity Arrangements**

The DRA legislation, denying either an intercorporate dividend deduction\(^{122}\) or a dividend tax credit\(^{123}\) in respect of a dividend received as part of a “dividend rental arrangement,” incorporates the combination of a purpose-based standard and a risk-exposure requirement. As currently conceived, the definition of a DRA is expressly purpose-based in the sense that the main reason for entering into the arrangement must be the receipt of a dividend in respect of the relevant shares.\(^{124}\) The arrangement must also be structured such that someone other than the recipient bears the risk of loss or enjoys the opportunity for gain or profit with respect to the shares “in any material respect.”\(^{125}\) By incorporating both of these standards, the DRA legislation also incorporates maximum costliness of application ex post. The requirement for a purpose-based inquiry in addition to a level of risk reduction is presumably included because of the especially vague expression of the latter, which could potentially affect non-tax-driven hedging.\(^{126}\) As well, potential overinclusiveness may be...
attributable to a specification of risk exposure that is altered in terms of either the downside or the upside rather than a material reduction of both.

The 2015 budget proposals extend the definition of a DRA to include a “synthetic equity arrangement,” which is defined in part to mean one or more agreements or other arrangements that have the effect of providing to a counterparty all or substantially all of the risk of loss and opportunity for gain or profit in respect of a share.127 The proposed definition incorporates the same expression of risk reduction as that used in the definition of an SDA and raises the same issues already noted in relation to that articulation of a required level of risk exposure.128 In addition, the proposed definition of an SEA attempts to refine the use of risk as a proxy for taxpayer purpose with a set of exceptions from SEA characterization even in the presence of what is a substantial level of risk reduction. In particular, the effect of SEA characterization is avoided where a taxpayer’s counterparty is not a tax-exempt or non-resident person (referred to as a “tax-indifferent investor”) or where the counterparty otherwise hedges its position; moreover, characterization as an SEA is avoided if the synthetic position is constructed through a “recognized derivatives exchange.”129 In each of these fact patterns, in contrast to the exclusively risk-based targeting of the SDA legislation, the fact that the specified level of risk reduction is inconsistent with an assumption of risk exposure and ownership is seen to be insufficient to attract the denial of dividend tax relief in favour of a more thoroughgoing identification of taxpayer purpose through these specified additional proxies.130

With the elaborate definition of a DRA, and particularly the proposed addition of the definition of an SEA, costliness of application is unavoidable—a concern that is acknowledged in the budget documents and in the stated intention of the Department of Finance to engage in consultation with a view to determining whether a simpler, yet still target-effective, response can be designed.131 One possibility is to follow the approach suggested here and redesign the definition of a DRA to incorporate an exclusively risk-based approach. More particularly, the existing risk-based standard, which requires that someone other than the shareholder bear the risk of loss or opportunity for gain or profit in “any material respect,” as well as the “all or

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127 Notice of ways and means motion, supra note 3, at resolution 32(1), amending the definition of “dividend rental arrangement” in subsection 248(1), and resolution 32(2), adding to that subsection the definition of “synthetic equity arrangement.”

128 See supra notes 106-111 and the accompanying text.

129 Notice of ways and means motion, supra note 3, at resolutions 32(1) and (2).

130 2015 Budget Plan, supra note 3, at 463. See, for example, Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada, “2015 Federal Budget—Synthetic Equity Arrangements: Submission by the Joint Committee on Taxation,” submission to the Department of Finance, May 26, 2015 (highlighting the potential overinclusiveness of the SEA proposals in the context of commercial share acquisitions incorporating provision for pre-sale dividends).

131 Ibid.
substantially all” standard incorporated in the proposed definition of an SEA, could be replaced with the precise specification of a level of risk exposure as a percentage amount comparable to that suggested above for the dividend stop-loss rules and the anti-foreign-tax-credit-trading rule applicable to short-term securities acquisitions. Risk exposure should also be specified fully in terms of both the downside and the upside associated with a position as proposed in the definition of an SEA. The additional condition in the existing DRA legislation that the main purpose for entering into the particular arrangement was to enable receipt of a dividend could be eliminated and replaced with an at-risk hold period requirement. Indeed, use of a specified level of risk reduction and a hold period requirement in the DRA legislation would provide clear rules for a set of reasonably foreseeable share acquisitions that would not necessarily be any less target-effective in distinguishing tax-driven from non-tax-driven share acquisitions. Moreover, by framing the required inquiries as an exercise in parallel drafting, each of the risk-based legislative overrides stipulating minimum at-risk hold periods could be applied in much the same way, thereby realizing economies of scale in the tax administrative function and perhaps even the tax compliance function.

Character Conversion Transactions—
Derivative Forward Agreements

The DFA legislation is conceptually related to certain other, more narrowly focused, overrides of ownership that address the separation of ownership and risk exposure to avoid a specified character of property that is assigned as an attribute of ownership. For example, the concept of “tracking property” addresses the attempt to avoid mark-to-market treatment for certain shares and specified debt obligations held by financial institutions using long derivative positions, or other intermediate entities, not otherwise subject to mark-to-market recognition. A similar tracking approach is used to address the attempt to avoid foreign accrual property income (FAPI) status on the insurance of Canadian risks by entering into swap arrangements.

132 Subsection 142.2(1), definition of “tracking property.” See Canada, Department of Finance, Legislative Proposals and Explanatory Notes Relating to the Income Tax Act, the Excise Tax Act, 2001 and the Excise Tax Act (Ottawa: Department of Finance, July 2008), at clause 26 (stating that the definition of “tracking property” is intended to “ensure that a financial institution will not be able to avoid mark-to-market treatment on properties by investing through an intermediary or through the use of another financial instrument (such as a derivative)”). The proposed, but never enacted, rules requiring inclusion of investment income from foreign investment entities (FIEs) included a similar concept of a “tracking entity,” which would not otherwise be a FIE but which derived entitlement to payment primarily from enumerated criteria with respect to a participating interest in a FIE. See Canada, Department of Finance, “Revised Legislative Proposals Released Relating to the Taxation of Non-Resident Trusts and Foreign Investment Entities and Other Technical Amendments to the Income Tax Act,” News Release no. 2005-049, July 18, 2005, proposed subsection 94.2(1), definition of “tracking entity,” and proposed subsection 94.2(9).
of a foreign policy pool for a pool of policies that includes the insurance of Canadian risks. These overrides have presumably been seen to be necessary in light of the longstanding CRA administrative position that long derivative positions in foreign property constitute property separate from the underlying risk exposure and would not be considered foreign property for the purpose of the former restrictions on foreign property holdings by registered plans and certain other taxpayers if the counterparty was a Canadian-resident issuer.

The DFA legislation is a more generalized override of the character of gain (or loss) that would otherwise be associated with ownership of capital property, including shares, treating such amounts realized on a disposition as non-capital amounts where the gain or loss is linked through derivative instruments to amounts, such as interest, that would be considered non-capital. For example, in the absence of the DFA legislation, a taxpayer with a hedged position in shares (or other property) could take the position that the amount of gain locked in by the hedge is on capital account when realized on a disposition, even though the gain could be considered equivalent to interest or other non-capital amount. Similarly, a taxpayer with a long derivative position in shares or other capital property could take the position that an acquisition and subsequent sale of a variable amount of shares or such property is on capital account, even though the purchase price (and the number) of the shares or other capital property is determined by reference to changes in value of an underlying that would be on non-capital account if owned by the taxpayer.

Hedged positions in shares (or other capital property) are potentially “sales agreements” within the definition of a DFA. This element of the definition is explicitly risk-based, requiring that the agreement eliminate a majority of the taxpayer’s risk of loss and opportunity for gain or profit in respect of the particular property. Expressed using a verbal formula, this level of risk reduction is readily converted to a precise specification of more than 50 percent, much like the accepted interpretation of the “all or substantially all” standard in the SDA legislation (90 percent or more). As it applies to hedged positions, the DFA legislation is notable for its incorporation of this relatively low level of risk reduction in combination with the determination of the sale price of the particular capital property with reference to an underlying interest. Other character conversion rules, such as the conversion transaction rule in

133 See 2013 Budget Plan, supra note 1, at 341-43, and resolution 35 of the accompanying notice of ways and means motion.
134 See Miller and Milet, supra note 8, at 10:3 (observing that forward agreements similar to those used in DFAs were used to avoid the former foreign property holding restrictions and were approved as doing so by the CRA); and Marcovitz and Van Loan, supra note 103, at 10:10 (observing that the CRA has indicated that equity derivatives are considered property for the purpose of the definition of “tracking property” in subsection 142.2(1), consistent with its administrative position under the former foreign property holding restrictions).
135 Paragraphs 12(1)(z.7) and 20(1)(xx).
136 Paragraph (c), definition of “derivative forward agreement” in subsection 248(1).
the United States,137 as well as a proposed anti-synthetic rule for interest equivalents in Australia,138 require a much higher level of risk reduction through the requirement that a long position in an asset be hedged such that any realized gain substantially replicates a return equivalent to interest.

As a targeting mechanism, a relatively high level of required risk reduction for the application of a character conversion rule is consistent with the attempt to avoid adversely affecting non-tax-driven hedging. The DFA level of 50 percent or greater shifts the boundary between tax-driven and non-tax-driven hedges so as to ensure that the vast majority of hedges in the former category are subject to the legislative override but potentially affects a significant range of hedges in the latter category. Shifting the boundary in this way to avoid underinclusiveness, while tolerating overinclusiveness, may reflect an intolerance for character conversion as a manipulation of ownership in the assignment of the character of gain or loss and may be a function of a muted policy enthusiasm for maintenance of the capital/income distinction when faced with the structured transactions that motivated the DFA legislation (mutual funds using the capital gain election in subsection 39(4) for their hedged positions in shares). Alternatively, Finance may have assumed that an acceptable level of risk reduction must be specified using the limited set of available verbal formulas. Constraining specification in this way arguably leaves a choice between a “majority” standard and an “all or substantially all” standard, since a standard of “materiality,” such as that under the DRA rules, may be ruled out as being too uncertain from a legal perspective. An “all or substantially all” standard would be consistent with the specification of the required risk reduction under the SDA legislation but might be considered too permissive, and therefore underinclusive, in the case of character conversion using sales agreements. A mixed characterization rule that would apportion capital and non-capital treatment based on relative exposures to capital and non-capital assets can presumably be rejected (or perhaps more likely, not even considered) as being too administrative- and compliance-intensive.

Long derivative positions in shares (or other capital property) are potentially “purchase agreements” within the definition of a DFA. Unlike “sales agreements,” this element of the definition is not risk-based, either explicitly or implicitly; instead, the difference between the fair market value of property delivered on settlement of

137 IRC sections 1258(c)(1) and (c)(2)(A) (defining a “conversion transaction” to include an acquisition of property covered by a substantially contemporaneous contract to sell the same or a substantially identical property where the covered position results in substantially all of the expected return being attributable to the time value of the taxpayer’s net investment).

138 ITAA 1997, proposed section 230-348W(1) (defining an “effective gain arrangement” to include one or more arrangements that provide a gain that is sufficiently certain); and proposed section 230-348T (providing that the object of subdivision 230-JB is to minimize tax deferral and arbitrage that would otherwise occur through arrangements that would allow circumstances to be brought into existence that would have substantially the same effect as, but do not take the form of, circumstances that give rise to gains that are sufficiently certain and to which the accruals method would apply).
the agreement and the amount paid for the property attracts the application of the legislation if the difference is attributable to an underlying interest. The apparent assumption is that all long derivative positions in shares (or other capital property) are tax-driven if structured such that the amount to be delivered is variable. The failure to specify any risk-exposure requirement as a targeting mechanism in the case of purchase agreements under the DFA legislation may again reflect a dissatisfaction with the limited set of alternative specifications using standard verbal formulas and a confidence that the legislative description of these agreements without a specified level of risk exposure is suitably target-effective. In this respect, the approach to the characterization of a long derivative position as a “purchase agreement” differs from the more restrictive character conversion rule in the United States applicable to derivative positions in hedge funds, which applies to recharacterize gain or loss on a position as a non-capital amount if substantially all of risk of loss and opportunity for gain is attributable to returns of the fund. The approach to long derivative positions under the DFA legislation also differs from the override for the purpose of mark-to-market treatment, which applies to require mark-to-market recognition if tracking property derives its fair market value primarily from a set of enumerated criteria that includes factors relevant to risk of loss and opportunity for gain or profit, as well as extending to revenue, income, cash flow, and any other similar criteria.

A similar approach to the characterization of a long derivative position in shares (or other capital property) as a “purchase agreement” subject to gain/loss recharacterization would include only those positions that provide risk exposure that is substantially invariant to the underlying non-capital property. Alternatively, a long derivative position in shares (or other capital property) could be excluded from recharacterization if, for example, a “majority” of the risk or “substantially all” of the risk was attributable to changes in the value of the shares. However, a level of risk exposure to the subject shares or other capital property consistent with the “majority” standard used in the case of “sales agreements” under the DFA legislation could be considered too permissive, and therefore underinclusive, in allowing relatively easy avoidance of the character conversion rule. Inclusion of only those long derivative positions that closely track a fixed non-capital return described by an “all or substantially all” standard would be potentially even more underinclusive, such that relatively modest alteration of risk exposure to the underlying could avoid recharacterization. On the other hand, an “all or substantially all” level of risk exposure to the underlying shares may be seen to be so narrow as an exclusion that the character conversion rule remains overinclusive, with the narrowly drawn exclusion adding very little of substance as a targeting mechanism. Possible overinclusiveness resulting

139 Paragraph (b), definition of “derivative forward agreement” in subsection 248(1).
140 IRC section 1260. As with the constructive sale rule in IRC section 1259, an “all or substantially all” standard is not explicitly specified but is instead implied by the description of the enumerated derivative positions. See the discussion in the text below at notes 168-170.
141 Subsection 142.2(1), definition of “tracking property.”
from a rejection of these verbal formulas to define a range of excluded long derivative positions is presumably tolerated to avoid underinclusiveness.142

The uniform approach to risk-based overrides of share ownership suggested here could be used as a more fine-grained and potentially more effective targeting of the DFA legislation applicable to both hedged positions (“sales agreements”) and long derivative positions (“purchase agreements”). It could draw the boundary between tax-driven and non-tax-driven hedging in a character conversion context at a higher level of risk reduction—say, the same illustrative 70 percent incorporated in other overrides—than the majority standard used in the case of sales agreements. Similarly, a long derivative position in shares could be excluded from gain/loss recharacterization if, following the example of the proposed dividend equivalent payment regulations in the United States, the risk exposure is 70 percent or greater than that associated with ownership of the shares.143 Moreover, as in the SDA legislation, the all-or-nothing consequences of the application of the DFA legislation could be muted, to some extent, using precise specification of risk exposure as a percentage amount to create three categories of hedged positions (sales agreements) and long derivative positions (purchase agreements) measured in terms of risk exposure to shares or other capital property:

1. less than 30 percent exposure (“sales agreements”)/less than 70 percent exposure (“purchase agreements”)—subject to gain/loss recharacterization;
2. greater than 50 percent exposure (“sales agreements”)/greater than 90 percent exposure (“purchase agreements”)—not subject to gain/loss recharacterization; and

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142 See, in this respect, New York State Bar Association, Tax Section, Report on Proposed Regulations Under Section 871(m), report no. 1306 (Albany, NY: NYSBA, May 20, 2014), at 25 (noting that most US practitioners use a delta standard of 0.8 in applying the constructive ownership rule in IRC section 1260 to determine whether all of the economic return with respect to a financial asset has been conveyed through a forward contract).

143 Prop. Treas. reg. sections 1.871-15(d)(2) and (e). See, in this respect, NYSBA report no. 1306, supra note 142, at 4 (suggesting that a delta threshold of 0.7 is too low and a threshold of at least 0.8 should be used); and Walker, supra note 94, at 20-21 (acknowledging that derivative positions that are imperfectly correlated with a long position in shares should be subject to the proposed dividend equivalent payment regulations but suggesting that a delta threshold of 0.8 would strike a better balance between tax-driven and non-tax-driven derivative positions). See also the preamble to prop. Treas. reg. section 1.871-15, supra note 26, at 839 (noting comments requesting that final regulations limit the scope of dividend equivalent treatment to derivative positions that provide delta 1 or near delta 1 exposure to a long position in shares, but also noting comments arguing that such an approach would provide non-delta 1 derivative positions with a competitive advantage over delta 1 positions because of inconsistent tax treatment); and New York State Bar Association, Tax Section, Report on Proposed and Temporary Regulations Under Section 871(m), report no. 1264 (Albany, NY: NYSBA, April 25, 2012), at 8-9 (observing that a majority of the members of the Tax Section believe that the dividend equivalent payment regulations should be limited to arrangements that are substantially equivalent to delta 1 exposure or are part of larger arrangements that provide that exposure).
3. exposure between 30 percent and 50 percent (“sales agreements”) / exposure between 70 percent and 90 percent (“purchase agreements”)—subject to a further inquiry into taxpayer purpose as the basis for recharacterization.

Here again, the policy maker would need to determine that precise specification improves the target-effectiveness of the risk-based override, at least in a general directional sense; moreover, it would need to be determined that the additional costliness associated with a purpose-based inquiry for hedged and long derivative positions within a problematic range of risk exposure is similarly warranted by improved target-effectiveness.

**Wash Sales**

In addition to the dividend stop-loss rules, a generalized set of stop-loss rules in the Act applies to “wash sales.” These rules reflect a similar legislative template and apply to deny the recognition of a capital or a non-capital loss where a taxpayer disposes of property, including shares, but maintains the same risk exposure to the property through an acquisition of the same (or an identical) property by the taxpayer (or an “affiliated” person) within a 61-day window around the date of the disposition (30 days before and 30 days after). Although not explicitly risk-based, this set of overrides of ownership in assigning loss recognition is implicitly risk-based as a proxy for taxpayer purpose. In particular, specification of a 61-day window as a condition for denial of loss recognition appears to be based on an empirical assumption that asset price volatility suggests that risk exposure associated with an acquisition outside the window is sufficiently different from the extreme case of a contemporaneous disposition and acquisition that the transactions can be characterized as non-tax-driven. A contemporaneous disposition and acquisition is the extreme case in the sense that there is a disposition as a matter of private law, but the identical risk exposure otherwise associated with ownership is maintained. In the absence of a legislative override, a loss would be recognized for income tax purposes based on ownership as a matter of private law as the basis for loss recognition. The 61-day window under the set of generalized stop-loss rules can thus be seen to serve as a proxy for risk exposure that serves as a proxy for taxpayer purpose, much like a hold

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144 The term “wash sale” is used to describe transactions that are subject to the generalized set of stop-loss rules in the Act, which in turn are referred to as “the wash sale rules” to distinguish them from the dividend stop-loss rules. These terms are more commonly used in the US context to refer to the comparable rules in IRC section 1091 and the transactions subject to these US stop-loss rules for capital losses.

145 With the exception of capital losses realized by an individual, the denied loss is recognized by the taxpayer subsequently when the property is disposed of to a person who is not affiliated with the taxpayer. “Superficial losses” are added to the adjusted cost base of the transferred property and recognized subsequently by the transferee on a disposition to a person who is not affiliated with the transferee. See paragraph 53(1)(f).
period requirement under the dividend stop-loss rules and the anti-foreign-tax-credit-trading rules applicable to short-term securities acquisitions.

The wash sale rules in the Act are potentially both underinclusive and overinclusive. They are underinclusive to the extent that the price of an asset, particularly a non-traded capital asset, is not especially volatile, so that an acquisition outside the 61-day window may still closely approximate the risk exposure of a contemporaneous sale and acquisition, but is treated as if it does not. The rules are overinclusive to the extent that the price of an asset, such as a publicly traded share, is especially volatile, so that an acquisition within the 61-day window may not approximate the risk exposure of a contemporaneous sale and acquisition, but is treated as if it does. Underinclusiveness may also be attributable to a failure to extend the rules to the entire range of long derivative positions that can be used to maintain the risk exposure associated with ownership of an asset within the 61-day window.146 In this respect, the wash sale rules extend to a “right to acquire property,” which is deemed to constitute an identical property.147 This extension appears to include simple derivative positions such as physically settled call options and forward contracts; it is much less clear whether it can be interpreted to extend to other long derivative positions that are cash settled, including a total-return swap.148

Recasting the wash sale rules as an override of ownership that is explicitly risk-based could potentially improve their target-effectiveness. For example, the rules could be recast along the lines suggested immediately above for “purchase agreements” under the definition of a DFA, to override ownership and deny the recognition of a loss wherever

- the taxpayer (or an “affiliated person”) enters into a long derivative position in respect of a disposed of asset at, or just before or after, the time of disposition;149 and
- the risk exposure of the long derivative position was, say, 70 percent or greater than the risk exposure associated with ownership of the asset.

146 See, for example, Schizer, “Scrubbing the Wash Sale Rules,” supra note 24, at 71-76 (describing strategies to avoid the application of IRC section 1091).
147 Clause 13(21.2)(e)(iii)(A); subsection 14(13); subsection 18(16); paragraph 40(3.5)(a); and paragraph (i), definition of “superficial loss” in section 54.
148 Schizer, “Scrubbing the Wash Sale Rules,” supra note 24, at 72-73 (discussing the possible failure of IRC section 1091 to apply to a swap as a replacement property providing the same risk exposure as a long position in property that is sold).
149 In the Australian context, see, for example, ITAA 1997, proposed section 230-348P (defining “effective retention arrangement” but proposing a risk-exposure standard of “all, or a substantial proportion”). In the US context, see Schizer, “Scrubbing the Wash Sale Rules,” supra note 24, at 78 (arguing that IRC section 1091 should be extended to dispositions of call options replaced by a long position in the underlying shares and short positions in shares replaced by put options written on the shares).
As a proxy for taxpayer purpose, targeting of the override would depend entirely on the specification of a level of risk exposure that could be seen to be sufficiently close to a contemporaneous sale and acquisition to warrant loss denial. However, legal uncertainty would be associated with a vaguely specified temporal connection between a disposition and entering into a long derivative position. An alternative would be to maintain a specified temporal window, as in the existing wash sale rules, accepting the target-ineffectiveness that is attributable to it. As with the illustrative risk-based specification of both the SDA and the DFA legislation, the targeting of the wash sale rules could be refined further by creating a range of problematic risk exposures (between 70 percent and 90 percent) that would warrant an inquiry into taxpayer purpose along with a safe harbour (less than 70 percent risk exposure) and categorical loss denial (90 percent or greater risk exposure) for those positions that are not considered to be as problematic in their characterization as non-tax-driven or tax-driven.

**SUPPRESSING DISCONTINUITIES USING A PURPOSE-BASED STANDARD**

Precise specification of a level of risk exposure as the basis for the application of an override of ownership in the assignment of tax attributes provides bright-line boundaries that result in sharp discontinuities whereby a small change in the risk exposure associated with a hedged or long derivative position in shares can avoid application of the risk-based override. This part of the article develops more fully the basis for the proposition suggested above that a direct inquiry into taxpayer purpose mandated by a targeted purpose-based standard is the preferable instrument to suppress discontinuities along the boundary between what are considered tax-driven and non-tax-driven positions. In particular, a purpose-based standard is preferable to the use of legal uncertainty to serve this function, while costliness of application is potentially mitigated somewhat by a focus on a limited set of positions that are clustered around a particular boundary.

**Discontinuities as a Focus of Tax-Driven Substitution**

Discontinuities are focal points for planning throughout the tax law and are a familiar problem for tax policy makers and tax administrators; they are associated

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150 But see Schizer, “Scrubbing the Wash Sale Rules,” supra note 24, at 76-79 (arguing for symmetrical treatment of positions under the constructive sale rule in IRC section 1259 and the wash sale rules in IRC section 1091, on the basis that the former permits relatively easy avoidance and deferral of gain recognition while the latter should eliminate loss-recognition strategies rather than induce the adoption of more sophisticated and wasteful planning).

151 Australia’s proposed stop-loss rules impose a purpose requirement that presumably is intended to screen out those acquisitions that may be sufficiently close temporally to a disposition but that are not motivated by the recognition of a loss for income tax purposes while maintaining the risk exposure associated with ownership of the asset. See ITAA 1997, proposed section 230-348P(e).

152 David A. Weisbach, “Line Drawing, Doctrine, and Efficiency in the Tax Law” (1999) 84:6 Cornell Law Review 1627-81 (arguing that the lack of a clear normative basis for the drawing of
with the drawing of boundaries where small changes in transactional form can produce disproportionate differences in tax treatment defined by the particular boundary. As a focus of tax planning, discontinuities effectively provide taxpayers with a choice of transactional form. On one side of a boundary is a higher-taxed transaction; on the other side is a lower-taxed transaction with similar non-tax features. Substitution of the lower-taxed transaction for the higher-taxed transaction occurs where the cost of sacrificing desirable non-tax features of the higher-taxed transaction is less than the tax savings provided by the substitution. Because it involves a sacrifice of desirable non-tax features associated with the higher-taxed transaction, substitution of the lower-taxed transaction is imperfect; it results in efficiency loss equal to the value of the desirable non-tax features that must be sacrificed to access the tax saving associated with the lower-taxed transaction. Tax planning focused on discontinuities is thus problematic not only for the revenue loss; it is also wasteful because it entails efficiency loss in addition to the transaction costs of implementing a lower-taxed substitute. In the absence of constraints on tax-driven substitution along a boundary in the tax law, the lower-taxed transaction will be substituted for the higher-taxed transaction until, at the margin, the loss in desirable non-tax features equals the available tax saving.

The risk-based overrides of share ownership that are the focus of this article attempt to address the substitution of a transaction by which share ownership as a matter of private law and risk exposure otherwise associated with ownership are separated in order to avoid treatment as a disposition, recognize a loss, transfer dividend tax relief or foreign tax credits, or convert the character of a gain from non-capital to capital.

These tax-driven transactions are themselves lower-taxed substitutes for higher-taxed transactions (or a non-transaction in the case of a wash sale) that otherwise leave ownership and full exposure to risk with the same taxpayer (without loss recognition in the case of a wash sale) or eliminate such exposure on a disposition. In drawing a distinction between what are assumed to be tax-driven and non-tax-driven positions in shares, this category of legislative overrides of ownership draws

boundaries at any particular point means that they should ideally be drawn on the basis of efficiency considerations, with a transaction being taxed consistently with its closest substitute, but a transaction should not be taxed too severely if there are other substitutes that taxpayers can access with associated efficiency costs). See also Jeff Strnad, “Taxing New Financial Products: A Conceptual Framework” (1994) 46:3 Stanford Law Review 569-605 (emphasizing the significance of discontinuities under a non-linear system of taxation of financial instruments). See Myron S. Scholes, Mark A. Wolfson, Merle Erickson, Michelle Hanlon, Edward L. Maydew, and Terry Shevlin, Taxes and Business Strategy: A Planning Approach, 5th ed. (Upper Saddle River, NJ: Prentice Hall, 2014).

a line in the tax law that itself becomes the focus of tax planning, rather than the transactional choice that would otherwise be available in the absence of the override. In effect, the boundary in the tax law becomes different, but the dynamic is the same. To realize the same desired tax treatment, taxpayers are required by a risk-based override to retain a specified level of risk exposure or, in the case of a long derivative position, to avoid a specified level of risk exposure.

One possible policy option to suppress discontinuities is elimination of a particular difference in tax treatment and its defining boundary that gives rise to tax-driven substitution. With the assignment of tax attributes to hedged and derivative positions in shares, this result could be realized by partial allocation based on relative risk exposure. Such an approach would be continuous in the sense that it would eliminate disproportionate “jumps” in tax treatment attributable to small changes in risk exposure. However, perceived administrative and compliance intensity arguably precludes this policy option, which necessitates the use of risk-based overrides of ownership and their associated discontinuities attributable to an all-or-nothing allocation of tax attributes contingent on the effective characterization of a hedged or derivative position as tax-driven or non-tax-driven.155 On the assumption that elimination of these relevant boundaries is not an option, the policy maker is left with a choice among a limited set of instruments to suppress discontinuities created by risk-based overrides. Not surprisingly, given the pervasiveness of boundaries in the tax law, the availability of these instruments is not unique to this type of legislation.

A potentially effective alternative approach to elimination of discontinuities is the definition of a boundary at a point where the policy maker can have confidence that differences in non-tax features completely constrain substitution of a lower-taxed transaction for a higher-taxed transaction. Referred to in the literature as “frictions,”156 these non-tax constraints can be found in various sources, including non-tax regulatory restrictions and financial accounting treatment; they also include constraints that are market-based in the sense that a transactional form required to

155 But see Schizer, “Frictions as a Constraint,” supra note 24, at 1364–68 (discussing a partial recognition approach to gain realization under a constructive sale rule applied to partially hedged positions in shares, but rejecting it as requiring a delta-based measure that is too administrative- and compliance-intensive and that can realize results that are inconsistent with an equivalent partial disposition of a block of shares). But see also United States Senate Committee on Finance, Revenue Reconciliation Act of 1997 (as Reported by the Committee on Finance), S rep. no. 105-33, 105th Cong., 1st sess. (1997), at 124 (indicating a preference for a pro rata approach to constructive sale treatment for partially hedged positions in appreciated assets).

156 See Gergen, supra note 82, at 834 (emphasizing the role of transaction costs, credit risk, and legal risk as constraints on tax-driven financial contracting); and Schizer, “Frictions as a Constraint,” supra note 24, at 1326–34 (reviewing business preferences, state of technology and markets, agency costs, credit risk, financial accounting treatment, and regulatory requirements as constraints on tax planning). See also Victor Fleischer, “Regulatory Arbitrage” (2010) 89:2 Texas Law Review 227–89 (extending the concept of transactional substitution to non-tax areas of law in order to avoid regulatory constraints and discussing legal, business, professional, ethical, and political factors that can constrain substitution).
access a tax treatment is not supplied by the market, or the cost of its supply is prohibitive. Whatever the source of a particular friction, the result is the same: although the substitution of a lower-taxed for a higher-taxed transactional form along a particular boundary is available in principle, it cannot be implemented in practice because of the binding nature of the non-tax constraint. A number of considerations, however, undermine a reliance on non-tax factors to constrain tax-driven substitution. For example, informational barriers can undermine the ability of the policy maker to identify non-tax constraints. Even where non-tax constraints can be identified, it is often difficult to know ex ante the extent to which any constraint is binding when particular taxpayers have differing degrees of tolerance for an identified constraint. Moreover, the binding nature of identified constraints must be monitored, since regulatory or financial accounting practice can change, while a previous failure of the market to supply a lower-taxed substitute can change with changing conditions, including the availability of tax-avoidance opportunities. Most importantly perhaps, unless an identified constraint prevents the entire range of possible substitutions along a boundary in the tax law, substitution will occur to the point at which the constraint is binding. The result is a different equilibrium than that which would prevail under an environment of unconstrained substitution; yet there is absolutely nothing to suggest that the revenue and efficiency loss that occurs up to that equilibrium point is a desirable policy result.

When non-tax factors serve as weak constraints or are unavailable, the policy maker must consider other instruments to suppress the discontinuities that are the source of tax-driven substitution. In this respect, there does not appear to be much in the way of binding non-tax constraints that could confidently be relied on to maintain a distinction between tax-driven and non-tax-driven positions in shares under overrides of ownership that use risk exposure as a proxy for taxpayer purpose. Indeed, the presence of relatively deep and liquid markets for traded shares and derivative instruments, in particular, as well as the availability of over-the-counter products, suggests

157 Raskolnikov, supra note 105.
158 See, in this respect, US GAO report, supra note 91, at 37-41 (emphasizing the need for more sharing of information between the IRS and other governmental agencies, such as the Securities and Exchange Commission and the Commodity Futures Trading Commission, as being critical to the identification of new financial products and emerging tax schemes requiring a response). See also, for example, Schizer, “Frictions as a Constraint,” supra note 24, at 1335-36 (observing that a reliance on frictions to constrain tax planning requires tax policy makers to learn a wide range of institutional detail, but noting that such detail tends to be acquired and applied on an ad hoc basis).
159 See, for example, Schizer, “Frictions as a Constraint,” supra note 24, at 1368 (observing that US policy makers did not anticipate that the ability of taxpayers to avoid the application of the constructive ownership rule in IRC section 1260 would be constrained by the unavailability of the necessary derivative instruments).
160 Schizer, ibid., at 1337 (noting that a reliance on frictions to constrain tax planning “can redistribute tax burdens in random or undesirable ways”).
that there is very little in the way of market-based non-tax constraints, other than transaction costs, on the creation of hedged and derivative positions in shares.\footnote{But see Farber, supra note 110, at 13-14 (suggesting that the proposed dividend equivalent payment regulations should focus on whether a counterparty can cheaply hedge, otherwise than by holding the underlying shares, and observing that a hedge becomes more expensive as the delta of a derivative position falls below 1). See also NYSBA report no. 1306, supra note 142, at 25 (arguing that parties attempting to earn dividend equivalents will not find it efficient to do so at deltas as low as 0.7 because such transactions would not sufficiently approximate economic returns associated with the underlying shares and would have materially higher transaction costs than high-delta transactions).}

This kind of market is especially conducive to counterparties serving as accommodation parties, since they are able to hedge out their own exposure at low cost and earn riskless fees for their services.\footnote{See, for example, Farber, supra note 110, at 14 (speculating on whether the use of delta under the proposed dividend equivalent payment regulations in the United States might be a proxy identifying those circumstances in which a counterparty might be expected to hold the underlying shares and the “expected avoidance value might be expected to exceed transaction costs”). See also Schizer, “Frictions as a Constraint,” supra note 24 (arguing that the constructive sale rule in IRC section 1259 and the constructive ownership rule in IRC section 1260 are both vulnerable to avoidance through relatively modest changes in economic return, but that avoidance of the latter is uncommon because of the inability of securities dealers to supply the necessary derivative instrument).}

As described in the next section, experience with the US constructive sale rule supports the proposition that the design of hedged positions in traded shares to manipulate boundaries under risk-based rules is, in fact, largely frictionless, at least in the absence of any obvious regulatory constraint or financial accounting constraint. In this market environment, the policy maker may choose among a menu of legal instruments, as an alternative to a reliance on non-tax constraints, to suppress discontinuities along the boundary between tax-driven and non-tax-driven hedged and derivative positions in shares under risk-based overrides of ownership.\footnote{Edgar, supra note 7, at 348-50.}

A Purpose-Based Standard as the Preferable Policy Instrument To Suppress Discontinuities

The following three legal instruments can be used to address tax-driven substitution along boundaries in the tax law generally, including the boundary implicated by risk-based overrides of ownership:

1. a lack of clarity in drawing a boundary,
2. a purpose-based standard, and/or
3. a GAAR and/or generalized judicial anti-avoidance doctrines.

These three instruments are not mutually exclusive and can be employed together. It is suggested here, however, that a purpose-based standard is the preferable legal instrument to maintain the boundary between tax-driven and non-tax-driven...
heded and derivative positions in shares under risk-based overrides of ownership.\textsuperscript{164} Lack of clarity in defining the boundary using imprecise verbal formulas tends to be eroded through the tax administration process, undermining the effectiveness of legal uncertainty as a constraint on tax-driven substitution. Moreover, as suggested earlier, inconsistency of application by the judiciary is a defining feature of a GAAR that is characterized by an exercise in statutory interpretation as an identification tool; it is therefore a potentially weak constraint on tax-driven substitution, and its use should be limited to transactions that cannot be anticipated. Because tax-driven adjustment of risk exposure to avoid the application of a risk-based override can be anticipated, reliance on a GAAR to suppress such substitution should be rejected, and an exclusively purpose-based standard should be used instead as a potentially robust constraint.

As an initial proposition, legal uncertainty is the principal property of the expression of a level of risk exposure as a standard under risk-based overrides of ownership,\textsuperscript{165} and the policy maker may use this imprecision as an instrument to suppress discontinuities along the boundary between tax-driven and non-tax-driven positions under risk-based overrides.\textsuperscript{166} In effect, the legal uncertainty attributable to an imprecisely specified standard may be relied on to constrain tax-driven hedged or derivative positions, since taxpayers must be willing to accept an element of legal

\textsuperscript{164} See, for example, Weisbach, supra note 92 (arguing that purpose-based anti-avoidance rules are an effective means to suppress discontinuities that are the focus of tax-driven transactions).

\textsuperscript{165} The explanatory notes to the definition of “synthetic disposition arrangement” in subsection 248(1) state only that “whether all or substantially all of a taxpayer’s risk of loss and opportunity for gain or profit in respect of property has been eliminated is highly factual”: \textit{Explanatory Notes}, supra note 94, at 62. To emphasize this point, the explanatory notes then suggest that risk of loss or opportunity for gain or profit may be considered to be eliminated even though there is some exposure to dividends, creditworthiness of a counterparty, or variability in interest rates or currency exchange rates, depending on the circumstances. This proposition and the enumerated factors are found in the proposed constructive sale rule in Australia: ITAA 1997, proposed section 230-348D(2).

\textsuperscript{166} The examples in the explanatory notes accompanying the definitions of “derivative forward agreement” and “synthetic disposition arrangement” in subsection 248(1) provide little in the way of informational content that would reduce legal uncertainty for partially hedged positions in shares with a level of risk exposure lying close to the boundary between tax-driven and non-tax-driven hedging specified by the verbal formulas in the legislation. The risk exposures in these examples are either clearly within or clearly outside the relevant boundary. See \textit{Explanatory Notes}, supra note 94, at 34, 59-60, and 63-65. Possibly instructive examples are two different equity collars in the explanatory notes accompanying the SDA definition (ibid., at 63). But the retention of the opportunity for gain of 2 percent in one of the examples (example 2—two-year put-call arrangement) is clearly trivial, assuming that price volatility of the underlying is non-trivial. The other example (example 3—five-year put-call arrangement) involves retention of 50 percent downside and upside risk, which is clearly outside the “all or substantially all” risk-reduction standard, assuming that the price volatility of the underlying is substantial. The importance of the assumptions regarding price volatility is discussed in the text below at notes 218-224. For a thorough review of the interpretive significance of the explanatory notes for the SDA legislation, see Miller and Milet, supra note 8, at 10:28-33.
risk to implement a position that is tax-motivated but that may or may not be classified as non-tax-motivated. The empirical assumption underlying reliance on legal uncertainty and the associated legal risk to constrain tax-driven substitution is that such risk adversely affects the pricing of those transactions that are intended to transfer tax attributes by separating ownership from exposure to risk or, alternatively, that legal risk adversely affects the value of the available tax benefit for a taxpayer implementing a strategy to attract a tax attribute to avoid a tax attribute. To avoid these adverse effects, a taxpayer must adjust risk exposure sufficiently to have some confidence that it will, in fact, be classified as non-tax-driven under a risk-based override of ownership. However, legal uncertainty can serve as a binding constraint on tax-driven substitution only if it can be assumed empirically with some confidence that affected taxpayers are unwilling to assume the risk exposure associated with the required adjustment of their hedged or derivative positions in shares. Moreover, as emphasized earlier, in the discussion of the choice between detailed rules and standards in the tax law, the binding constraint that would otherwise be created by legal uncertainty is invariably undermined by the tax administration process, with the determination of the content of a standard unfolding ex post as transactions are undertaken and classified on one side or the other of a boundary. The experience with the constructive sale rule in the United States provides an instructive illustration of this policy dynamic that can arise with an imprecisely expressed level of risk exposure.

Since 1997, the US Internal Revenue Code (IRC) has included a provision addressing constructive sales. Unlike the SDA legislation, the US constructive sale rule does not explicitly indicate a required level of risk reduction; it is implied

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167 See Mark P. Gergen and Paula Schmitz, “The Influence of Tax Law on Securities Innovation in the United States: 1981-1997” (1997) 52:2 Tax Law Review 119-97 (emphasizing the significance of tax-law uncertainty as a friction that constrains tax-driven innovation of publicly traded securities because of the pricing effect for tax clienteles, but also observing that the effect is weakened by administrative guidance intended to clarify tax treatment). But see also Schizer, “Frictions as a Constraint,” supra note 24, at 1317, note 10 (noting that legal uncertainty does not always serve as an effective constraint on tax-driven substitution and citing the issuance of debt exchangeable into common shares [DECS] as an example).

168 IRC section 1259.

169 A short sale against the box is included only if the offsetting positions are in the same or a substantially identical property (IRC section 1259(c)(1)(A)). An offsetting NPC (notional principal contract) is included only if it pays all, or substantially all, of the investment yield on a long position and provides for reimbursement of all decreases in value (IRC section 1259(c)(1)(B)). A forward contract must cover a long position by providing for delivery of a substantially fixed amount of property for a substantially fixed price (IRC section 1259(c)(1)(C)). A long purchase must cover an appreciated short position in the same or a substantially identical property (IRC section 1259(c)(1)(D)). IRC section 1259 also includes transactions that have substantially the same effect as any of the enumerated transactions to the extent that they are prescribed by the secretary of the Treasury (IRC section 1259(c)(1)(E)). This regulatory power has not been exercised.
instead in the requirement that each of the enumerated transactions subject to the rule consist of substantially offsetting positions. This requirement has been understood by tax practitioners as implying that significant variation, taken to mean 20 percent or more, of the exposure associated with an underlying and the exposure associated with a hedge is sufficient to avoid application of the rule. The accepted interpretation was developed in the context of two different sets of transactions designed to closely approximate the elimination of risk exposure associated with a sale while avoiding such treatment.170 One set of transactions arose in the corporate sector and involves tailoring of a hedged position through the issuance of contingent payment debt intended to monetize an appreciated position in the shares of an unrelated corporation held by the issuer.171 Two notable examples are debt exchangeable into common shares (DECS)172 and premium equity participating securities

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170 See Hayward, supra note 9, at 1773-80 (reviewing different examples of monetization strategies).

171 Schizer, “Frictions as a Constraint,” supra note 24, at 1318 (suggesting that the ease with which IRC section 1259 can be avoided was understood by government officials when the constructive sale rule was enacted and was “tolerated for reasons of politics and administrability”). See also Hayward, supra note 9, at 1799-1801 (noting that the original proposal for a constructive sale rule in the United States would have resulted in disposition treatment where there was elimination of substantially all of the risk of loss and opportunity for gain, but the replacement of this standard with the enumerated set of transactions and the extension of regulatory authority to other transactions with substantially the same effect have resulted in underinclusiveness); and NYSBA report no. 1306, supra note 142, at 25-26 (observing that forward contracts providing for delivery of an amount of cash or shares subject to significant variability are not forward contracts for the purpose of IRC section 1259, which requires delivery of a substantially fixed amount of property or cash for a fixed price).

172 As the equivalent of a fixed-payment debt instrument and an embedded on-market forward contract written on a long position in shares of a corporation other than the issuer, exchangeable debt normally eliminates all of the risk associated with that position. DECS are a variation of exchangeable debt and are structured such that the issuer retains sufficient upside appreciation to avoid the application of the constructive sale rule. See William M. Gentry and David M. Schizer, “Frictions and Tax-Motivated Hedging: An Empirical Exploration of Publicly-Traded Exchangeable Securities” (2003) 56:1, part 2 National Tax Journal 167-95, at 174 (characterizing the tax bar as being very confident that the constructive sale rule would not apply to a partial hedge by which the taxpayer retains the first 20 percent of appreciation in the underlying property [as in a DECS transaction], and suggesting that it is doubtful that many of these transactions have been deterred by legal uncertainty). See also Edward D. Kleinbard and Erika W. Nijenhuis, “Everything I Know About Financial Products I Learned from DECS,” in Tax Law and Practice Course Handbook Series (New York: Practicing Law Institute, 2001), 1183-1234. Another version of exchangeable debt, referred to as “PHONES,” is equivalent to the issuance of a long-term put option on referenced shares held by the issuer. In a typical issue, the holder of a PHONES is entitled to a below-market rate of interest plus dividends paid on the referenced shares and, on maturity, may receive the greater of the issue price of the PHONES (equal to the spot price of the referenced shares on issue) and the spot price of the referenced shares on maturity. Because the issuer retains the risk of loss on the referenced shares, the constructive sale rule may not apply. See Lee Sheppard, “Rethinking DECS, and New Ways To Carve Out Debt” (1999) 83:3 Tax Notes 347-52, at 349-50 (arguing that the retention of the risk of loss by the issuer of PHONES is insignificant in light of their 30-year
Another set of comparable transactions arose with high-wealth individuals holding appreciated positions in shares and involves the use of either zero-cost collars or variable prepaid forward contracts (VPFCs).

In Revenue ruling 2003-7, the Internal Revenue Service (IRS) confirmed that a VPFC with a kinked payout structure would not be subject to the constructive sale rule because of the “significant variation” in the taxpayer’s delivery obligation. The

PEPS are, in form, unsecured debt instruments, issued for a price equal to the spot price of referenced shares held by the issuer. PEPS have a limited term (commonly five years) and pay interest at a below-market rate. On maturity, the holder is entitled to cash equal to the spot price of the referenced shares. PEPS also provide the issuer with a redemption option during the latter portion of the term of the security. The option is equivalent to a call option with payment terms that permit the issuer to retain a portion of any appreciation in the referenced shares. Like DECS, PEPS are arguably outside the constructive sale rule, because the issuer retains a portion of the equity upside sufficient to support the conclusion that all or substantially all of the risk exposure associated with a long position in the referenced shares has not been eliminated. See Lee A. Sheppard, “Adding PEP to the Constructive Sale Debate” (1996) 70:13 Tax Notes 1592-96.

Under a zero-cost collar, a taxpayer with a long position in appreciated shares issues a call and purchases a put written on the shares for equal premiums (hence the “zero-cost” label). In contrast to a married put and call, with a zero-cost collar the exercise prices of the options differ and provide a price range within which the taxpayer is again exposed to sufficient risk to avoid the application of the constructive sale rule. The long position in the shares can be monetized by acquiring low-cost financing secured against the collar. See, in this respect, Schizer, “Scrubbing the Wash Sale Rules,” supra note 24, at 77-78 (suggesting that a call spread of 20 percent is accepted as sufficient risk exposure for a partially hedged position to avoid the application of IRC section 1259 and arguing that comparable risk exposure should be used as the basis for determination of a replacement position under the wash sale rules).

VPFCs are structured to provide payouts comparable to those of zero-cost collars. VPFCs differ from standard forward contracts in that an upfront payment is received by the taxpayer writing the forward contract over the share position. On maturity of the contract, the taxpayer receives no additional payment and must deliver a variable number of shares, depending on their value at that time, or pay an amount equal to that value. The payout under the VPFC is structured such that the taxpayer retains the value of the shares within a specified range, which provides a kink in the payout profile (hence the label “kinked forwards” or “kinky forwards”).

taxpayer in the ruling owned 100 shares with a value of $20 per share on entering into the VPFC, which provided that the taxpayer was to deliver on maturity, in kind or in cash, (1) all 100 shares if the per share value was $20 or less; (2) the number of shares having a value of $2,000 if the per share value was between $20 and $25; or (3) 80 shares if the per share value was greater than $25. The taxpayer was thereby protected from any subsequent decline in value below the market price of $20 per share, retained all possible gain between $20 and $25 per share, and retained 20 percent of any gain in excess of $25 per share. The taxpayer also retained all dividend rights. In concluding that the constructive sale rule did not apply, the ruling focuses on the extreme potential values under the delivery obligation of either 100 or 80 shares as the basis for a characterization of the VPFC as a forward contract that leaves the taxpayer with sufficient risk exposure. The same characterization of VPFCs is reflected in the subsequent decision in Anschutz.177 The VPFCs considered in that case protected the taxpayer from any decline in value below the initial value, while the taxpayer retained all gain in excess of 150 percent of that value and gave up all gain between 100 percent and 150 percent. The taxpayer also retained all dividend payments on the underlying shares if the share price was less than the initial value or greater than 150 percent of that value. Where the share price was between these two amounts, the taxpayer retained a portion of the dividend payments. Consistent with Revenue ruling 2003-7, the court focused on the extreme potential values (in kind or in cash) under the delivery obligation for the taxpayer of either (1) all shares (where share value is less than the initial value) or (2) 66.66 percent of all shares (where share value is 150 percent of the initial value).178 It was accepted that the constructive sale rule did not apply because the “ultimate delivery obligation may vary by as much as 33.3 percent,” with the taxpayer thereby retaining sufficient risk exposure. Also consistent with Revenue ruling 2003-7, it was held that the presence of a securities lending agreement between the taxpayer and the counterparty financial institution, which facilitated a short sale of the shares as a hedge of the long forward position, resulted in a sale under an indeterminate “benefits and burdens” approach to the characterization of ownership. In the absence of a “benefits and burdens” gloss on the private-law concept of share ownership, the CRA would presumably have to rely on GAAR in section 245 to address the same kinds of transactions that are designed to avoid application of the SDA legislation.

More generally, the experience with the US constructive sale rule illustrates the inevitable erosion of legal uncertainty and the associated legal risk that can occur with the imprecise expression of risk exposure using verbal formulas under risk-based overrides. The erosion occurs as the content of the standard expressed by the formula is articulated ex post in the context of particular transactions, and the resulting

177 Supra note 65.
178 For share value between 100 and 150 percent of the initial value, as well as share value in excess of 150 percent, the number of shares under the delivery obligation was a variable amount between the extremes of 66.67 percent and 100 percent.
risk-based overrides of share ownership as specific anti-avoidance rules

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clarity of the boundary between tax-driven and non-tax-driven hedging exposes the standard to tax-driven substitution. Verbal formulas such as “all or substantially all” of risk exposure in the SDA legislation and the SEA proposals, or a “majority” of risk exposure in the DFA legislation in the context of sale agreements, are especially weak as constraints on tax-driven substitution, because they come prepackaged with content that has been articulated in the context of other provisions. Expressing the required level of risk reduction using a verbal formula like the “materiality” standard in the DRA rules constitutes a difference in degree, and not one of kind. Although a standard such as “materiality” does not necessarily come with the same level of existing content as the verbal formulas “all or substantially all” and “majority,” the content of the standard will also inevitably be revealed ex post through the tax administration process. Indeed, as emphasized above in respect of the different types of overrides in the Act, the principal difference between a precise specification of a required level of risk exposure and its expression as an imprecise verbal formula remains a matter of legal process, with specification being revealed ex post through the tax administration process rather than ex ante as a rule.

An ultimate similarity of result under a precise specification of risk exposure as a percentage amount and an imprecise specification using a verbal formula means that both approaches suffer from the same vulnerability, and both approaches require a purpose-based standard to most effectively suppress discontinuities and the tax-driven substitution that they engender along the boundary between tax-driven and non-tax-driven positions in shares. A purpose-based standard is a specific anti-avoidance rule that requires a direct inquiry into taxpayer purpose in determining the application of the rule to deny the tax treatment otherwise available under the relevant provision for a transaction, or to subject such transaction to a tax treatment that it was intended to avoid. A purpose-based standard supersedes GAAR and substitutes a legally determinate, but factually uncertain, inquiry into taxpayer purpose as the exclusive means to determine the application of a particular risk-based


180 See, for example, 2015 Budget Plan, supra note 3, at 463, and resolution 32(2) of the accompanying notice of ways and means motion (proposing that a series of transactions will be deemed to be a DRA where the transactions have the effect of eliminating all or substantially all of the taxpayer's risk of loss and opportunity for gain or profit in respect of a share if the purpose is to avoid characterization as a DRA). In the US context, see prop. Treas. reg. section 1.871-15(n) (permitting the commissioner to treat any payment with respect to a transaction as a dividend equivalent payment to the extent necessary to prevent avoidance of the application of the proposed regulations where a taxpayer, either directly or through a related person, acquires a transaction or transactions with the principal purpose of avoiding the application of the proposed regulations).
override to transactions that might otherwise avoid its application. The factual uncertainty concerns the determination of the purpose of a taxpayer in structuring a transaction that accesses a tax treatment or avoids a tax treatment under the relevant provision. Yet in contrast to the legal uncertainty associated with other imprecisely specified standards, an inquiry into taxpayer purpose does not necessarily reveal anything about the content of the standard as applied to another taxpayer and can remain robust as a constraint on tax-driven substitution. Although there may be some inconsistency in the articulation of this inquiry in particular fact patterns, the inconsistency would almost certainly be much less pronounced than that under GAAR, which involves the same inquiry into taxpayer purpose as well as a misuse or abuse analysis as an exercise in statutory interpretation. The binding constraint of a purpose-based standard can also be enhanced by specifying that the requisite purpose is “one of the main purposes” of a transaction, thereby perhaps avoiding arguments over the characterization of the relative strengths of the tax-avoidance purpose and possible non-tax reasons for the adoption of a particular position in shares. Costliness of the execution of a purpose-based standard may also be tolerable because of a limited focus on the subset of partially hedged positions in shares and long derivative positions that provide partial risk exposure clustered at or near the specified boundary between tax-driven and non-tax-driven positions.

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181 But see NYSBA report no. 1306, supra note 142, at 54-55 (recommending that the anti-abuse rule under the proposed dividend equivalent payment regulations be limited by the requirements that the relevant transaction or transactions provide the substantial economic equivalent of an investment in the stock of a US corporation and that the transaction or transactions was or were structured with a principal purpose of avoiding the application of the proposed regulations).

182 See generally US GAO report, supra note 91, at 29 (recognizing that the issuance of guidance by Treasury or the IRS can provide new opportunities for tax abuse, particularly when derivative instruments can be altered easily to achieve a desired tax effect).

183 See Nathan Boidman, “‘One of the Main Purposes’ Test” (2014) 22:5 Canadian Tax Highlights 9-10 (noting that the phrase “one of the main purposes” or an equivalent phrase—“one of the main reasons,” “one of the main objectives,” or “one of the principal purposes”—appears in the Act at least 79 times). In the Australian context, see ITAA 1997, proposed sections 230-348D(4), 230-348Q(4), and 230-348X(2) (a tax-avoidance purpose under the proposed set of anti-synthetic rules need not be the dominant purpose of a hedged or derivative position, but it must not be a merely incidental purpose).

184 See, for example, Hayward, supra note 9, at 1769 and 1780-81 (noting that synthetic dispositions may be implemented to avoid price pressure from a block sale or to avoid contractual or regulatory restrictions on a sale transaction). See also Wortsman et al., supra note 8, at 8:3-4 and 8:21-22 (suggesting that synthetic dispositions also may be undertaken to diversify a taxpayer’s portfolio while retaining voting rights, and character conversion transactions may be undertaken to allow retail investors indirect access to investments not otherwise available directly).

185 See Boidman, supra note 183, at 9-10 (arguing that a “one of the main purposes” test is conceptually incoherent because there cannot be more than one main purpose and reviewing the limited case law considering the phrase, which has ignored the incoherence and has reduced the requirement in applying the test to “one of the purposes” or “one of the important purposes”). See also Joint Committee on Taxation of the Canadian Bar Association and
Application of a Purpose-Based Standard for Different Specifications of Risk Exposure

The need for a purpose-based standard to suppress discontinuities along the boundary between tax-driven and non-tax-driven positions in shares is greatest where the particular boundary under a risk-based override is drawn relatively tightly to avoid any adverse effect on positions that are not tax-driven. Drawing the boundary in this manner is especially vulnerable to alteration of a position in order to fall on the side of the boundary that is effectively assumed to be non-tax-driven. As the US experience with synthetic dispositions illustrates, a lack of non-tax constraints on this behaviour, other than a willingness to assume some additional market risk and transaction costs, means that taxpayers will readily engage in alteration of their positions to avoid an undesirable tax treatment that would otherwise result from the application of a risk-based override of ownership in the assignment of a tax attribute.

As described in part two, a precise specification of risk exposure as a percentage amount allows for the articulation of a safe harbour, as well as a category of positions in shares that is considered more problematic in their motivation. Although possibly improving the target-effectiveness of a risk-based override, this feature creates multiple boundaries as a focus of tax planning. For example, it was suggested that a safe harbour under a constructive sale rule could be drawn at a level of risk reduction of 70 percent or less on the empirical assumption that partially hedged positions with risk exposure of 30 percent or more indicate a dominant non-tax purpose. Risk reduction of 90 percent or more could attract treatment as a disposition, with a range of problematic partial hedges being defined as those with risk-reduction levels greater than 70 percent and less than 90 percent. For these partial hedges, an inquiry into taxpayer purpose in establishing the hedge would be required to characterize it as tax-driven or non-tax-driven. However, this inquiry would likely have to be extended to partial hedges with risk-reduction levels just below 70 percent if it were suspected that a hedge could be adjusted to move to a position in shares within the safe harbour and avoid an inquiry into taxpayer purpose as the basis for constructive sale treatment. Again, there seems to be very little of significance in terms of taxpayer tolerance for risk exposure that would suggest that a 70 percent level is a binding constraint on such behaviour. Unless transaction costs can confidently be relied on as a constraint, safe-harbour characterization can be framed as a rebuttable presumption and contingent on an inquiry into taxpayer purpose.

A character conversion rule similarly appears to suffer from the same vulnerability as a constructive sale rule to tax-driven alteration of hedged and derivative positions. And this vulnerability seems to be present when the required level of risk reduction for a hedged position in shares is drawn at any point in excess of 50 percent. For example, if this level were drawn at 70 percent, as suggested for illustrative

Chartered Professional Accountants of Canada, “Consultations on Treaty Shopping: Submission by the Joint Committee on Taxation,” submission to the Department of Finance, December 11, 2013, at 13-14 (criticizing the use of a “one of the main purposes” test as an approach to treaty shopping).
purposes in part two, any level of risk reduction below that level would result in
characterization as a non-tax-driven hedge, and the risk-based override of share
ownership would not apply to recharacterize gain as a non-capital amount. The
70 percent level would thus provide the functional equivalent of a safe harbour,
much like that under a constructive sale rule, and would arguably require a purpose-
based standard to suppress the resulting discontinuity for partially hedged positions
clustered around the boundary. Lowering the level of required risk reduction to a
“majority” of the risk of loss and opportunity for gain/profit, as it is specified for
sale agreements under the DFA legislation, may do little to alleviate this vulnerability.
In effect, a lowering of the level of risk reduction in this way represents a difference
in degree rather than one of kind if there is nothing in the way of binding non-tax
constraints on tax-driven alteration of partial hedges that can be attributed to the
particular lower level. In the absence of evidence of a jump in transaction costs along
the specified boundary between tax-driven and non-tax-driven hedging, a purpose-
based standard should therefore probably be used to constrain tax-driven alteration
of positions clustered around the boundary under a character conversion rule by
taxpayers who are not otherwise constrained by intolerance for additional risk ex-
posure. This policy prescription would seem to hold equally in the event that a level
of risk exposure were specified for long derivative positions in shares within the
definition of a purchase agreement under the DFA legislation and for the purpose
of the wash sale rules. It would also seem to hold for the purpose of the dividend
stop-loss rules, the anti-foreign-tax-credit-trading rule, and the DRA rules and SEA
proposals where these rules incorporate an at-risk requirement in the application of
a hold period requirement.

One possible difference related to the architecture of these risk-based overrides
that could negate the need for a purpose-based standard concerns a plausible empirical
assumption concerning short-term share acquisitions around a dividend payment
date that is the occasion for the availability of dividend tax relief or a foreign tax
credit. Because of the short-term nature of these transactions, it might be the case
that taxpayer intolerance for risk is greater than it is with synthetic dispositions or
character conversion transactions. If that is the case, the level of risk reduction that
would attract application of any of these risk-based overrides could be specified at a
relatively high level that would define the category of affected partially hedged pos-
itions narrowly. However, the policy maker would have to have confidence that the
resulting boundary was drawn at a point where, because of a heightened intolerance
for additional risk exposure, taxpayers would be constrained in making small changes
to their partially hedged positions in order to avoid application of the relevant over-
ride and thereby maintain entitlement to dividend relief or foreign tax credits.

MEASUREMENT OF RISK EXPOSURE
The discussion to this point has proceeded on the premise that risk exposure can be
measured with sufficient precision that risk-based overrides of ownership are cred-
ibly administrable. In fact, this measurement exercise is required whether the level
of risk exposure is expressed as a verbal formula or more precisely as a percentage amount. It may therefore be somewhat surprising that, in the context of risk-based overrides that explicitly use risk exposure as a proxy for taxpayer purpose, the measurement of risk exposure appears to be conducted on an ad hoc basis with no clear guidance, even in a broad sense, as to what methodology or methodologies may be used.\textsuperscript{186} It may be the case that a combination of the expression of levels of risk exposure using imprecise verbal formulas and the lack of any measurement guidance is seen to provide suitable flexibility in determining risk exposure, and this flexibility is considered a desirable policy property given an evident mistrust of the administrative integrity of formal measurement models.

It is suggested in this part of the article that the financial concept of delta could be used to measure risk exposure with positions in traded shares, primarily because it provides policy makers with greater flexibility in drawing a boundary between tax-driven and non-tax-driven positions by specifying a level of risk exposure as a percentage amount. Delta may be intractable, however, as a measurement tool for positions in non-traded shares and other types of capital property that are subject to risk-based overrides of ownership. In principle at least, different approaches could be used for traded shares and non-traded shares, as well as capital property more generally. For example, non-traded shares and other capital property could be subjected to overrides that combine the expression of a level of risk exposure using an imprecise verbal formula with the factual uncertainty that follows from a failure to specify any measurement methodology. Traded shares could be subjected to overrides that combine the precise specification of a level of risk exposure as a percentage amount with a required delta-based measure. If the policy flexibility provided by a precise specification is not seen to warrant separate risk-based overrides, the alternative legislative pattern is continued use of coarse-grained expressions of risk exposure through a limited set of verbal formulas, although nothing prevents the use of delta, where practical, through administrative practice under the same specification.\textsuperscript{187}

\textbf{Methodological Indeterminacy as an Approach to Risk Measurement}

Where risk exposure is used as a proxy for taxpayer purpose, the characterization of a particular position in shares (or other property) requires measurement and comparison of the exposure associated with an open position and the exposure associated with a hedged or derivative position. This measurement exercise, in turn, requires

\textsuperscript{186} See Miller and Milet, supra note 8, at 10:26-28 (citing the US legislative history with IRC section 1259 and suggesting that the similar standard in the definition of “synthetic disposition arrangement” in subsection 248(1) of the Act results in methodological indeterminacy).

\textsuperscript{187} See Miller and Milet, supra note 8, at 10:27 (suggesting that a delta-based measure of risk exposure would be attractive to those seeking a measurement tool in applying a 90 percent or more risk-reduction test for the purpose of the SDA legislation).
some type of accounting for asset price volatility and the volatility of dividend distributions. Consider, for example, a simple married put and call. Assume that a block of shares is currently trading at $100 and the prevailing riskless interest rate is 5 percent for the relevant time horizon. At one extreme, an open position exposes the holder to a maximum loss of $100, while any appreciation in value is captured as gain with, in theory, no limitation. At the other extreme, a fully hedged married put and call position eliminates all exposure to loss (other than that attributable to counterparty risk) and any chance of gain in excess of the riskless interest rate. The latter result can be realized by (1) purchasing an at-the-money put option with an exercise price of $100; and (2) selling an out-of-the-money call option with an exercise price of $105. In between these two extremes, however, is a range of partially hedged positions. One possible point in this range consists of (1) the purchase of an out-of-the-money put option with an exercise price of $90 and (2) the sale of an out-of-the-money call option with an exercise price of $110. The long position in the shares is partially hedged because the purchased put option protects the holder from loss if the price of the shares moves below $90. The position is also partially hedged on the upside because the sold call option requires the holder to pay out any appreciation above $110. This partially hedged position leaves the holder with a maximum risk of loss of $10 and a maximum gain of $10 ($5 expected gain equal to the riskless interest rate + $5 unexpected gain attributable to changes in the price of the shares). The fully hedged position leaves the holder with no risk of loss and a maximum gain of $5 equal to interest at the riskless rate (plus or minus any gain/loss attributable to differences in the amount of the option premiums).

Even with this simple example, a comparison of the risk exposure associated with an open position and the risk exposure associated with the partially hedged position

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188 NYSBA report no. 868, supra note 24, at 11 (noting that the expected yield and price volatility of a position in an underlying, as well as the terms of a hedge, are all relevant to a determination of whether a taxpayer has substantially eliminated risk of loss and opportunity for gain, and doubting that there is a single bright-line methodology for all transactions). See also S rep. no. 105-33, supra note 155, at 126-27 (stating that, in the exercise of the legislative power to write regulations specifying transactions under IRC section 1259 with substantially the same effect as the four enumerated transactions, it is anticipated that Treasury will address equity collars and, in doing so, will take into account various factors with respect to an appreciated financial position, including the yield and price volatility of shares and the period and other terms of the options).

189 See NYSBA report no. 868, supra note 24, at 12-13. See also Explanatory Notes, supra note 94, at 59 (example—put/call).

190 The locked-in return of $5 could be subject to a character conversion rule such as the DFA legislation. Any appreciation on the underlying shares on entering the hedge would be subject to a constructive sale rule such as the SDA legislation, while the locked-in gain should not be accounted for in determining satisfaction of the relevant risk exposure. See Explanatory Notes, supra note 94, at 33-34 (example—non-recourse loan) (referred to in Miller and Milet, supra note 8, at 10:29, note 57). See also NYSBA report no. 868, supra note 24, at 11 (noting that “locked-in” amounts that do not depend on changes in the value of an underlying should generally be ignored in measuring opportunity for gain).
can only be executed with any factual integrity by accounting for the probability that the price of the shares, on implementation of the partially hedged position, will fall to any point from $90 to zero or will rise above any point from $110 to infinity. If there is a trivial, or only a minimal, chance that the share value will move outside a price range of $90 to $110, it may be confidently concluded that the partially hedged position is sufficiently close to an open position to justify consistency of tax treatment. On the other hand, if there is a likely chance that the price will move below $90 or above $110, it may be confidently concluded that the level of risk exposure associated with the partially hedged position is not sufficiently close to an open position to justify consistency of tax treatment. Confident conclusions about the character of the partially hedged position can be drawn only if the price volatility of the shares in this simplest of examples is accounted for in measuring the associated risk exposure.\textsuperscript{191}

The explicitly risk-based overrides in the Act do not specify any particular method of measurement of risk exposure. This lack of measurement specification appears to be closely associated with the expression of a level of risk exposure using an imprecise verbal formula rather than a precise percentage amount. The resulting legislative pattern is characterized by both legal uncertainty and factual uncertainty. As emphasized in parts two and three, legal uncertainty is attributable to the quantitatively imprecise specification of a level of risk exposure using verbal formulas. Tax administrators and taxpayers are unclear as to the precise point at which a boundary between tax-driven and non-tax-driven hedging is drawn, although the tax administration process tends to bring some clarity to the boundary as the content of the verbal formula is developed ex post in the context of hedged and derivative positions. Factual uncertainty is attributable to the lack of any stipulated measurement of risk exposure, but unlike legal uncertainty, it is not necessarily clarified by the tax administration process. The fact that a particular approach to the measurement of risk exposure is used in the context of a particular position does not mean that it translates to another position.\textsuperscript{192}

In fact, the tax administration process, including limited case law, under various risk-based overrides in Canada and other countries reveals little, if anything, that is instructive about the approach to the measurement of risk exposure with hedged and derivative positions. In the absence of any specification of a methodological approach to the measurement of risk exposure that would account for asset price volatility, as well as dividend volatility in the case of shares, an apparently plausible approach is to simply ignore volatility and determine the level of risk exposure using

\textsuperscript{191} See Brennan, supra note 24, at 267-68 (criticizing the holding in Rev. rul. 2003-7 and the decision in \textit{Anschutz} for their failure to account for asset and price volatility in considering the application of IRC section 1259 to a VPFC). See the discussion in the text above at note 176 and following.

\textsuperscript{192} See \textit{Explanatory Notes}, supra note 94, at 62 (characterizing the determination of whether all or substantially all of the risk of loss and opportunity for gain or profit has been eliminated as “highly factual”).
extreme values as realistic possibilities. Because of an obvious inability to provide any kind of weighting to upside or downside risk, this simplified approach presumably also dictates that risk of loss and opportunity for gain or profit be assessed independently rather than as a whole in determining the risk exposure of a position. It may not be an overstatement, therefore, to suggest that the lack of any indication as to what methodologies are acceptable, and in what circumstances they are acceptable, leaves the determination of risk exposure for the purpose of risk-based overrides as an ad hoc “back-of-the-envelope” exercise, with assessments of volatility being made in a casual and informal manner rather than by the use of a systematic or standardized approach. The factual uncertainty is that much greater when volatility of dividend distributions, as well as asset price volatility, must be accounted for with positions in shares. Failure to adequately account for volatility also undermines the target-effectiveness of risk-based overrides, with underinclusiveness being the more likely feature, since taxpayers are free to elect alteration of their positions on either the downside or the upside as the basis for avoidance of the stipulated standard.

The lack of guidance, whether legislative or administrative, regarding the measurement of risk exposure is curious, at least with hedged and derivative positions in shares, given that the financial concept of delta, in particular, measures directly what the tax law requires to be measured under risk-based overrides of share ownership. That is, risk exposure associated with a hedged or derivative position in shares is quantified by taking into account both asset price and dividend volatility, while implicitly assigning weights to risk of loss and opportunity for gain or profit through

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193 See, for example, supra notes 168-178 and the accompanying text regarding the experience with IRC section 1259. All of the examples in the explanatory notes to the DFA and SDA legislation reflect this approach, and there is no mention of how volatility is to be assessed. See Explanatory Notes, supra note 94, at 34, 59-60, and 63-65. The importance of volatility to an assessment of risk exposure is acknowledged, however, in the explanatory notes where it is stated that an equity swap limited to dividend equivalent payments would not be considered to be an SDA for the equity payer with a long position in shares where the price of the shares is volatile and therefore most of the equity payer’s risk of loss and opportunity for gain or profit is attributable to changes in the value of the shares: ibid., at 65 (example 2—swap).

194 See Miller and Milet, supra note 8, at 10:28 (noting that the expression of risk exposure as “risk of loss and opportunity for gain or profit” could be interpreted as requiring either a combined assessment of downside and upside risk or an independent assessment, but observing that certain examples in the explanatory notes to the SDA legislation indicate that Finance accepts the latter interpretation).

195 See, for example, Rev. rul. 2003-7, supra note 176 (concluding only that the taxpayer’s delivery obligation under the VPFC entails “significant variation”).

196 See, for example, NYSBA report no. 868, supra note 24, at 16 (suggesting the use of a rebuttable presumption rather than a safe harbour if risk of loss and opportunity for gain are assessed independently for the purpose of applying a constructive sale rule).

197 See Brennan, supra note 24, at 273-74 (arguing that the use of delta to measure risk exposure would improve the target-effectiveness of IRC section 1259 by avoiding discontinuities under a “benefits and burdens” analysis of share ownership whereby small changes in some features can result in different tax treatment for positions with the same delta values).
an assessment of volatility. In this respect, Australian and US policy makers have deviated from standard legislative practice by explicitly mandating the use of delta as a measurement of risk exposure for certain risk-based overrides of share ownership. This limited use of delta is arguably suggestive of those circumstances in which the measurement tool may be most suitable, with the policy gains from the enhanced targeting of risk-based overrides outweighing the administrative and compliance costs. In particular, a delta-based measure may be especially well suited to risk-based overrides that employ a hold period requirement as a targeting mechanism or to risk-based overrides in the context of character conversion transactions using long derivative positions in shares.

Use of a Delta-Based Measure as an Exception to Methodological Indeterminacy

As noted in part two, the anti-dividend-credit-trading rules in Australia198 and the proposed dividend equivalent payment regulations in the United States199 specify a level of required risk exposure precisely as a percentage amount. More particularly, they stipulate that risk exposure is to be measured using the financial concept delta, which is one of a set of risk measures used by options traders.200 Delta measures the rate of incremental price change between a derivative instrument and an underlying position;201 in other words, it provides the ratio of the price change of a derivative instrument and an underlying asset, such as a share, and is most commonly associated with dynamic hedging strategies.202 Both the Australian rules and the US proposed regulations incorporate the concept of “position delta,” which uses delta to determine the required hedge ratio between a derivative instrument and a long or short position in an asset.

Stated very generally, the Australian rules require a taxpayer to calculate a net position for the period during which they hold a share each time that a position is entered into by the taxpayer. A position in respect of a share is anything that has a delta in relation to the share.203 A taxpayer with a net position that has a delta of 0.3 or less is considered to have “materially diminished risk of loss and opportunity for

198 See supra note 25.
199 See supra note 26.
200 See John C. Hull, Options, Futures, and Other Derivatives, 9th ed. (Englewood Cliffs, NJ: Prentice Hall, 2014), chapter 19. Other measures are (1) vega (rate of change of the delta of an option with respect to a change in volatility), (2) theta (rate of change of the value of a portfolio of options with respect to the passage of time), (3) gamma (rate of change of the delta of an option with respect to the price of the underlying asset), and (4) rho (rate of change of the value of a position with respect to the interest rate).
201 Hull, supra note 200, at 285 and 402-3.
202 Ibid., at 403 (the goal of dynamic hedging as an arbitrage trading strategy is the construction and maintenance of a delta-neutral position, which means that the delta of a share position is offset by the delta of an option position and results in a net position delta of zero).
203 ITAA 1936, former section 160APHJ(2).
gain,” with the result that days on which the delta of the net position is less than 0.3 are not counted in determining satisfaction of the hold period requirement for dividend credit entitlement. For this purpose, a share is allocated a delta of positive 1, and the deltas of derivatives held or issued in combination with the share are added (long positions) or subtracted (short positions) in determining a net position. The proposed US regulations specify that dividend compensation payments under a “specified notional principal contract” (NPC) or a “specified equity linked instrument” (ELI) with respect to shares of a US corporation will be treated as dividends to a non-resident recipient for withholding tax purposes if the delta of the long derivative position under the NPC or the ELI is 0.7 or greater than that associated with ownership of the shares. Status as a specified NPC or ELI is tested by reference to the delta of the relevant derivative position when the long party acquires the transaction. As under the Australian rules, the deltas of multiple transactions are aggregated in determining the delta of the composite long position.

The combination of the precise specification of risk exposure as a percentage amount and the specification of delta as the basis for measuring the exposure of a hedged or derivative position in shares provides a risk-based override of ownership with the properties of legal certainty and a potentially enhanced factual certainty attributable to specification of a measurement methodology. There remains factual uncertainty surrounding the calculation of delta, which is closely related to option

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204 ITAA 1936, former section 160APHM.
205 ITAA 1936, former section 160APHO(3).
206 ITAA 1936, former section 160APHJ(4).
207 ITAA 1936, former section 160APHJ(5).
209 Prop. Treas. reg. section 1.871-15(e). An “equity linked instrument” is a financial transaction, other than a securities lending or sale-repurchase transaction or an NPC, that references the value of one or more underlying securities. Prop. Treas. reg. section 1.871-15(a)(4). Specific examples include a futures contract, forward contract, option, debt instrument, or other contractual arrangement that references the value of one or more underlying securities.
210 Prop. Treas. reg. section 1.871-15(g)(1). “Delta” is defined as the ratio of the change in the fair market value of an NPC or ELI to the change in the fair market value of the property referenced by the NPC or ELI.
211 Prop. Treas. reg. section 1.871-15(a)(7). “Long party” is defined as the party to a potential section 871(m) transaction with respect to an underlying security that is entitled to a dividend equivalent payment. Prop. Treas. reg. section 1.871-15(a)(7)(i). “Short party” is defined as the party to a potential section 871(m) transaction with respect to an underlying security that is liable for a dividend equivalent payment. Prop. Treas. reg. section 1.871-15(a)(7)(ii).
212 Two or more transactions entered into by a long party (or a related person) are treated as a single transaction if they reference the same underlying security and are entered into in connection with each other. Prop. Treas. reg. section 1.871-15(f).
pricing models and requires the application of suitably complex mathematical formulas. Even so, the calculation of delta for simple positions in options is reasonably straightforward, while on-market forward contracts have a delta of 1. More complex calculations are required for more complex derivative positions, which generally must be decomposed into a known set of basic instruments. In all instances, however, the more problematic inputs are asset price volatility and dividend volatility (as well as the nature of dividends as fixed or proportionate to value). The specification of these critical parameters requires the application of both mathematical expertise and an exercise in judgment; but the factual uncertainty is at least confined for both the tax administration and taxpayers as compared with risk-based overrides that do not specify a measure of risk exposure. Despite these desirable properties, the use of delta tends to be viewed skeptically in the literature as too compliance- and administrative-intensive. This characterization presumably follows

213 Hull, supra note 200, at 403 (“Delta is closely related to Black-Scholes-Merton analysis”).

214 Ibid., at 402-24, describing delta hedging.

215 Ibid., at 404-5 (calculation of delta of European share options). See, in this respect, NYSBA report no. 1306, supra note 142, at 32 (suggesting that the calculation of delta can be made simpler where a broker or dealer is not involved, by permitting the long party to use commonly available online tools but subject to a condition that the necessary inputs, such as the interest rate curve and volatility numbers, are within a range of commercially acceptable variation). See also Schizer, “Frictions as a Constraint,” supra note 24, at 1365, note 188 (referring to the availability of online tools for the computation of delta for simple derivative instruments and suggesting that the government could offer presumptions based on typical facts to spare taxpayers from the need to do computations, although the inaccuracy of such presumptions could undermine the rationale for the use of delta).

216 Hull, supra note 200, at 420-21.

217 See, for example, Farber, supra note 110, at 14 (characterizing delta as “an unwieldy and imprecise concept” whose functionality is debatable because it cannot be applied coherently in not uncommon fact patterns, such as digital options that provide a fixed payout once a specified threshold price is exceeded); and Walker, supra note 94, at 20 (noting that delta is difficult to apply to derivatives with more complex economics than a simple total return swap referencing an equity security). An example of the complexity of calculation that is required for more complex derivative positions is provided by Brennan, supra note 24, at 264-74 (calculating delta for the VPFC that is the subject of Rev. rul. 2003-7, as well as the VPFCs at issue in Anschutz). See also NYSBA report no. 1306, supra note 142, at 26-31 (describing a series of examples requiring a disaggregation approach to the calculation of delta and noting the difficulty with digital options because there is no objectively determinable number of shares).

218 See Nassim Nicholas Taleb, Dynamic Hedging: Managing Vanilla and Exotic Options (New York: Wiley, 1996), at 88-95 (calculating price volatility directly from past price movements or indirectly from the price of traded options on shares). See also Hull, supra note 200, at 425 (noting that delta hedging is based on the assumption that asset price volatility remains constant); and Miller and Milet, supra note 8, at 10:28, note 54 (emphasizing that some measures of risk exposure are based on an assumed invariant level of distributions that focuses the measure on asset price, which is not the standard under the SDA legislation, while asset price volatility tends to be a trailing measure and is not a direct measure of market expectations of such volatility).

219 See, for example, the sources cited in note 24, supra.
from the fact that there is no particular pricing model that fits all circumstances; instead, the computation methodology for the determination of delta requires an exercise in judgment that commonly involves a choice as to the use of option pricing models. Both taxpayers and the tax administration are thus required to obtain suitable financial market expertise with a delta-based measurement of risk exposure as an element of the targeting of risk-based overrides of share ownership.

Yet there is nothing unique about the need for expertise with the use of a delta-based measurement of risk exposure. Any number of factual determinations under the Act, such as the determination of fair market value or an acceptable transfer price, requires the employment of expert evidence, and this requirement arguably remains tolerable for compliance and administrative purposes. As with both of these other factual determinations, the necessary data and calculations are normally generated for non-tax purposes, which in the case of delta will commonly be housed with a broker-dealer who can be required to provide the relevant information to the tax administration on behalf of a taxpayer with a hedged or derivative position in shares. Moreover, the administrative and compliance burden assumed to be associated with the use of delta is overstated if there is no accounting for the administrative and compliance burden associated with the standard legislative practice of failing to specify a measurement of risk exposure under risk-based overrides. Less rigorous

220 But see Miller and Milet, supra note 8, at 10:28 (emphasizing that formal risk-measurement methodologies may not be available to, or capable of being applied by, all taxpayers and CRA auditors).

221 See, in this respect, prop. Treas. reg. section 1.871-15(g)(1) (“For purposes of this section, the delta of an NPC or ELI must be determined in a commercially reasonable manner. If a taxpayer calculates delta for non-tax purposes, that delta ordinarily is the delta used for purposes of this section”). See also Mark J. Laurie, Liam Collins, and John Murton, “The 45 Day Holding Period Rule—The Ultimate Walnut Crusher” (1999) 2:3 Journal of Australian Taxation 122-48, at 128-29 (observing that the term “delta” is undefined legislatively on the apparent assumption that its common usage in the finance industry will prevail but suggesting that the value of delta may be calculated differently depending on the taxpayer’s perception of the relationship between a derivative and an underlying share, while difficulties are created for taxpayers who enter into transactions for which there is “no readily ascertainable delta”).

222 For example, prop. Treas. reg. section 1.871-15(o) requires brokers and dealers that are parties to a potential section 871(m) transaction to provide information on request to the counterparty, and where there is no broker or dealer, the short party must provide the information. See also Alison Noble, “The Holding Period and Related Payment Rules: Are You Qualified for Franking Credits?” August 10, 2010 (Deloitte Touche Tohmatsu, Sydney), 1-23, at 11 (“There may be a number of ways to calculate the delta, and the tax legislation does not specify how a delta is to be calculated. Delta is frequently calculated by option traders. The delta may not, however, be known by a taxpayer if shares and positions are held directly, rather than through a broker or managed account, or if the position is something for which a delta is not usually calculated by participants in the financial market. This presents some practical difficulties for taxpayers in calculating their net position for shares”); and Walker, supra note 94, at 20 (noting that derivatives dealers typically compute delta to establish an appropriate hedge of their positions and should be in a position to provide this information to counterparties).
assessments of risk exposure are probably less administrative- and compliance-intensive, but the reduction in cost comes at the price of a loss of precision. In short, casual or informal assessments of risk exposure are coarse-grained, although they probably arrive at a plausible result in extreme cases that are clearly within or outside the level of risk exposure described under a risk-based override of ownership. But the extreme cases are not the problematic ones along the boundary between tax-driven and non-tax-driven hedged or derivative positions in shares defined by risk-based overrides. With the problematic cases of positions with risk exposures that lie along the boundary, it is not as clear that the tax administration or taxpayers can be confident in a characterization that is based on an informal assessment of risk exposure, and a more systematic accounting of price and dividend volatility for such positions in shares should be required. In fact, failure to specify a measure of risk exposure does not preclude the use of delta alongside other approaches that may vary in their analytical rigour.

Where the policy maker specifies the use of delta, it may even be the case that a compliance and administrative dynamic will result that is comparable to that when a methodological approach to the measurement of risk exposure remains unspecified. For those positions that are clearly within or outside the level of risk exposure under a risk-based override, taxpayers and the tax administration presumably do not have to expend significant (if any) compliance and administrative resources. By far the greatest expenditure of these resources would be reserved for problematic positions that lie close to the boundary and that require some precision of measurement, given the associated tax consequences. This tax administration dynamic is again comparable to valuation and transfer-pricing inquiries where factual uncertainty allows for a range of acceptable determinations and methodologies that are scrutinized, with attendant administrative and compliance costs, only where the outer bounds of the

223 See, for example, IRC v. Scottish Provident, [2005] STC 15 (HL) (concluding that a sale and purchase of call options on government bonds issued together with the same counterparty, to take advantage of a gap in the transition to the application of capital gains tax to such options, did not involve exposure to risk because the value of the underlying government bonds was unlikely to fall within a range that would result in an unexpected gain or loss).

224 See NYSBA report no. 1306, supra note 142, at 31-32 (suggesting the use of surrogates for delta where obtaining information for the calculation of delta is not practical because, for example, the relevant positions are exchange-traded and do not involve a broker or dealer, while the short party may not have sufficient expertise to generate the required delta calculation). See also NYSBA report no. 868, supra note 24, at 13-17 (discussing an “option pricing” approach to the measurement of risk exposure whereby the price of put and/or call options written on shares would be compared with the price of comparable options that eliminate all risk exposure, but acknowledging that such an approach is workable primarily with liquid options markets and otherwise requires the use of option pricing models that entail some subjectivity in the assessment of share price volatility, not unlike a delta-based measure); and S rep. no. 105-33, supra note 155, at 127 (suggesting that regulations under IRC section 1259 consider the use of option prices and option pricing models in the assessment of risk exposure associated with a partially hedged position).
range are at issue. The unique issue under risk-based overrides, emphasized in part three, is the discontinuity that arises from the drawing of a boundary between tax-driven and non-tax-driven positions, which makes these overrides vulnerable to alteration of a hedged or derivative position to ensure inapplicability. As Brennan illustrates in the context of the US constructive sale rule, the assumptions that define the parameters of a pricing model used to calculate delta as a measure of risk exposure can lead to discontinuous tax treatment attributable to small differences in delta that cause characterization of a hedged or derivative position in shares to fall on one side or the other of the boundary between tax-driven and non-tax-driven positions. As with a fair market value or transfer-pricing determination, differences in critical assumptions can be entirely plausible factually, particularly as they relate to future asset price and dividend volatility; but the use of delta as a measure of risk exposure under a risk-based override of ownership can have discontinuous tax consequences for plausible assumptions, and this is not necessarily the case with a transfer-pricing or valuation inquiry, which tends to lack the same bright-line boundaries as legislative parameters under risk-based overrides even where the level of risk reduction is expressed using imprecise verbal formulas. The kind of purpose-based standard suggested in part three can be adopted to constrain alteration of hedged or derivative positions in shares, as well as the tailoring of pricing models and resultant delta, where either is done in an attempt to avoid application of a risk-based override. The standard can also backstop legislative specification, if any, of broad parameters that must be incorporated in modelling techniques. Indeed, tailoring of modelling parameters would presumably be closely associated with the alteration of a position that lies along the boundary between what are considered tax-driven and non-tax-driven positions under a risk-based override.

Although perceived administrative and compliance costs may be overstated, the use of delta to measure risk exposure under risk-based overrides should probably remain limited. Two generalized features of delta as a measurement tool tend to suggest why its unqualified use is problematic: (1) the need for asset price history; and (2) a focus on incremental price changes. With respect to the first feature, it is notable that Australian policy makers have not proposed the use of delta as a measure

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225 Brennan, supra note 24, at 264-74.
226 Walker, supra note 94, at 20-21 (characterizing delta as an imperfect proxy for dividend equivalence that requires the support of specific anti-abuse rules and citing as an example a long derivative position in shares that provides dividend equivalent payments but no exposure to changes in value of the underlying shares).
227 See, in this respect, Macnaughton and Mawani, supra note 97, at 917-21 (recommending legislative prescription of valuation techniques for employee stock options for the purpose of determining the amount of a contribution to a registered retirement savings plan or a tax-free savings account).
228 See, for example, prop. Treas. reg. section 1.871-15(n) (permitting the commissioner to adjust the delta of a transaction where the anti-abuse rule applies).
of risk exposure in the set of proposed anti-synthetic rules as part of the larger legislative project on the taxation of financial arrangements. These proposals, which include a constructive sale, a character conversion, and a wash sale rule, follow instead the standard legislative pattern of specification of a level of risk exposure using a verbal formula while failing to specify any particular approach to measurement. Similarly, the preamble to the proposed dividend equivalent payment regulations in the United States provides that the use of delta is not to be interpreted as an approval of its use in other legislative contexts. The resultant limited use of delta to measure risk exposure in the context of hedged and derivative positions in shares for the purpose of the Australian anti-dividend-credit-trading rules and the US proposed regulations for dividend equivalent payments may be attributable to the fact that the pricing methodologies underlying delta are tractable for positions in shares but not necessarily other types of property that tend to be thinly traded. Most importantly, the integrity of the pricing models on which the calculation of delta is invariably based requires sufficient asset price history as the basis of volatility parameters.

Because delta measures the change in price of a derivative instrument relative to small incremental changes in the price of an underlying asset, it is also probably best suited as a measurement tool for the purpose of those risk-based overrides that incorporate hold period requirements. This feature of delta means that it changes as the passage of time reveals changes in the price of the underlying asset that require rebalancing of a hedged position with a dynamic hedge strategy. For the purpose of a hold period requirement, an approach based on a taxpayer’s net position in shares, such as that reflected in the Australian anti-dividend-credit-trading rules, fits readily with a delta-based measure of risk exposure. Where a net position changes as a hedge is rebalanced, delta can be recalculated with respect to the rebalanced position to test for the required level of risk exposure for each day within the

229 See supra note 14.

230 Preamble to prop. Treas. reg. section 1.871-15, supra note 26, at 841 (“This notice of proposed rulemaking should not be construed as providing guidance with respect to any other section of the Code. For example, this notice should not be used as a basis for applying the delta standard to interpret other Code sections”).

231 See Brennan, supra note 24, at 275 (noting that there would be difficulties in computing delta for illiquid assets under a delta-based measure for constructive sale purposes). See also Miller and Milet, supra note 8, at 10:28 (observing that the precision provided by “formal mathematical methodologies” to measure risk exposure is limited to assets trading in liquid markets with sufficient price history to derive volatility estimates); and NYSBA report no. 868, supra note 24, at 18 (suggesting that evidence regarding the fundamentals of an underlying business could be relevant in establishing a range of expected future share values that could bear on an assessment of risk exposure of a partially hedged position in shares).

232 Hull, supra note 200, chapter 19.

233 See NYSBA report no. 868, supra note 24, at 20 (noting that a delta-based measure of risk exposure avoids the issue of establishing an appropriate time horizon, which is problematic with an option pricing approach).

234 Hull, supra note 200, at 405-8.
specified hold period. Without some qualification on its use, delta is not necessarily well suited, however, for those risk-based rules, such as a constructive sale rule, that apply to deem a disposition or other tax consequence to arise once a specified level of risk exposure occurs. For example, use of delta to measure risk exposure can result in a deemed disposition of an asset where the required level of risk reduction is considered to occur simply because of a change in the price of the underlying, necessitating a recalculation of delta, even though the net position is a “hedge-and-forget” strategy235 with no rebalancing of the position. A deemed disposition could occur despite the fact that the hedge was constructed as a partial hedge outside the level of risk reduction specified under a constructive sale rule at the time the taxpayer entered into the position and was not subsequently altered.236

Irrespective of perceived administrative and compliance costs, there is therefore a defensible case for the cautious use of delta to measure risk exposure for the purpose of risk-based overrides of share ownership. Indeed, the lack of any particular measurement tool that can be used with confidence for property other than shares, as well as thinly traded shares, undermines greatly the precision realized by specification of a level of risk exposure as a percentage amount. In effect, the ability to choose any point within a range of risk exposure as the boundary between tax-driven and non-tax-driven positions is largely meaningless if the risk exposure of any particular hedged or derivative position cannot be measured with equivalent precision. Policy makers may be left with no choice of instrument other than a choice among a limited set of points within a range of risk exposure that can be described using verbal formulas such as “all or substantially all,” “majority,” or even “material.” It is possible, of course, to specify the same risk-based rules differently for shares and for other property (and even thinly traded shares), but this legislative alternative could result in additional compliance and administrative costs as compared with a single rule applicable to both shares and other property.237 It is unclear empirically whether any gain in precision of specification for hedged and derivative positions in shares would warrant the additional costs.

If the gain in target-effectiveness from precise specification of risk exposure is in fact seen to be warranted, positional delta can, in principle, be used for both risk-based overrides of share ownership that incorporate a hold period requirement and those overrides that create tax consequences when, at any time, the stipulated level of risk exposure is not maintained. In effect, stipulating that delta is to be calculated only when a net position in shares is entered into, or is altered, ensures that a change

235 Ibid., at 403 (referring to the implementation of a hedge without subsequent adjustment as “static hedging” or “hedge-and-forget”).

236 See NYSBA report no. 868, supra note 24, at 20-21.

237 A differently specified rule is provided for foreign tax credit trading transactions in non-capital property and short-term securities acquisitions held as non-capital property subject to the hold period requirement in subsection 126(4.2). See subsection 126(4.1) (identifying foreign tax credit trading transactions as those that lack economic profit).
in delta without any change in a net position does not give rise to the application of tax consequences under a risk-based override. However, the use of positional delta leaves open the application of an override to a dynamically hedged portfolio with constant rebalancing of a net position. The rebalancing, which is invariably non-tax-driven, can result in tax consequences under risk-based overrides, even though such overrides are targeted at what is considered to be tax-driven hedged or derivative positions, which tend to be associated with hedge-and-forget strategies that are commonly structured transactions. For traders or dealers who mark their portfolios to market on income account for income tax purposes, the need for an exception to a risk-based override is limited to those overrides that incorporate a hold period requirement. For institutional investors, such as mutual funds, that are subject to realization-based recognition of gain or loss, which may be on capital account, both types of risk-based overrides are implicated and arguably require an exception to refine the targeting otherwise provided through the specification of a level of risk exposure. One possibility is a “portfolio election,” such as that under the Australian anti-dividend-credit-trading rules, which permits qualifying taxpayers to claim a maximum amount of credits on share portfolios without application of the hold period requirement. Designing the boundaries of a suitable exception is nonetheless a difficult proposition, given the policy imperative to exclude hedge-and-forget strategies from the exception in order to ensure that it is not abused.

In the absence of a broadly focused dividend equivalent payment rule in the Act focused on tax-avoidance transactions, the DRA rules, as modified by the proposed incorporation of the SEA provisions, appear to be the most obvious target for legislative revision using a delta-based measurement of risk exposure. The combination of an imprecisely specified level of risk exposure and a required inquiry into taxpayer purpose means that the DRA rules are characterized by both legal uncertainty

238 ITAA 1936, former section 160APHR and former section 160AQZE. See, in this respect, Laurie et al., supra note 221, at 141 (characterizing the formula-based ceiling election as a concession to institutional investors and large retail investment managers that are considered to be low-revenue risk and otherwise have considerable difficulty in meeting the hold period requirement because of substantial share turnover). For administrative and compliance cost reasons, a de minimis exemption from the hold period requirement is also available for individuals whose dividend credit claim for a taxation year does not exceed A$5,000. See ITAA 1936, former section 160APHT.

239 NYSBA report no. 868, supra note 24, at 21-22 (observing that it would be a mistake to exclude dynamic hedging from a constructive sale rule if such an exclusion would lead to substantial abuse, but suggesting that traders and non-dealers not subject to mark-to-market taxation do not present sufficient concern to justify extension of constructive sale treatment to dynamic hedging strategies).

240 The SLA rules address the treatment of dividend equivalent, as well as interest equivalent, payments: subsections 260(5) and (8). The Act does not, however, include an anti-avoidance rule addressing dividend equivalent payments associated with long derivative positions generally in shares.
and factual uncertainty, with the kinds of attendant costs emphasized in this article. Both legal and factual uncertainty could be moderated by providing instead for

- a hold period requirement,
- a requirement that shares be held at risk for the hold period,
- specification of a required level of risk exposure as a percentage amount, and
- measurement of risk exposure using delta.

The other obvious possibilities for similar revision are the anti-foreign-tax-credit-trading rule applicable to short-term securities acquisitions and the dividend stop-loss rules. These overrides already have hold period requirements, but could also be recast to replace the weak at-risk standard of the SDA legislation with a higher level of required risk exposure and a requirement that delta be used to measure risk exposure. Given a lack of price data necessary for modelling purposes, it is not clear, however, how delta could be used as a measurement tool for non-traded shares any more effectively than it could for property other than shares. Although market unavailability of suitable hedging instruments may constrain a range of tax-driven positions, the need to apply each of these risk-based overrides to non-traded shares seems clear on the likely empirical assumption that such positions are not completely constrained by the unavailability of accommodation parties and their ability to hedge out their risk exposure.241 The policy imperative to address partially hedged positions in both traded and non-traded shares means that the principal legislative reform options to the status quo are

- differently specified DRA rules, dividend stop-loss rules, and anti-foreign-tax-credit-trading rules for traded and non-traded shares; and
- the same precisely specified rules for both traded and non-traded shares.

The attractiveness of the first alternative again depends on an assessment that any possible gain in target-effectiveness from a precisely specified rule for traded shares warrants the additional administrative and compliance cost of two separate sets of risk-based rules to address the same policy issue. The attractiveness of the second alternative depends on an assessment that the limitations of the use of delta in the context of non-traded shares are insufficient to outweigh the gains captured by the legal and factual certainty characteristic of a precisely specified rule. In this respect, the Australian anti-dividend-credit-trading rules and the proposed US dividend equivalent payment regulations both extend to positions in traded and non-traded shares.

241 See, for example, Gentry and Schizer, supra note 172, at 178-89 (analyzing 61 transactions between 1993 and 2001, and finding that an offering of exchangeable securities as a hedging technique to avoid IRC section 1259 was associated with a decline of almost 4 percent in the underlying share price before implementation of the hedge).
CONCLUSION

This article has conceptualized a set of specific anti-avoidance rules in the Act as risk-based overrides of share ownership in the assignment of tax attributes. It suggests that these rules, which include the recently enacted DFA and SDA legislation and the recently proposed SEA provisions, could be made more target-effective if they were recast to specify risk exposure, as a proxy for taxpayer purpose, explicitly as a percentage amount. Two important constraints, however, undermine realization of this policy goal. One constraint is the lack of systematic empirical evidence of the motivation for particular positions in shares that would suggest where precisely the boundary between tax-driven and non-tax-driven positions should be drawn under each of the risk-based overrides. This lack of empirical evidence means that precise specification of risk exposure as a percentage amount remains a necessarily blunt instrument that can potentially improve target-effectiveness in a general directional sense only, with the relevant direction suggested by a casual empiricism grounded in anecdotal evidence. The other constraint is the need for a systematic and factually credible approach to measurement of risk exposure that can be applied across risk-based overrides. A delta-based measure, which is suggested and rejected in some of the literature as too administrative- and compliance-intensive, could in fact prove feasible for traded shares, with some legislative guidance being provided by its use under the Australian anti-dividend-credit-trading rules and the proposed US dividend equivalent payment regulations.

Yet, beyond simple derivative positions, a delta-based measure is not entirely tractable for property other than shares and is much less tractable in the case of non-traded shares than it is with publicly traded shares. In the absence of any other obvious method of risk measurement, the policy maker is left to choose among policy options that are all suboptimal to some extent. One policy option is maintenance of the status quo, which is characterized by an eclectic set of explicit and implicit specifications of risk exposure as proxies for taxpayer purpose. Another choice is a more limited application of this status quo to property other than shares under those overrides that apply to both shares and other capital property. Risk-based overrides could be recast for positions in shares using precise specification of risk exposure as a percentage amount and a delta-based measure of risk exposure. A third option is comprehensive application across all risk-based overrides to all types of property using an imprecise verbal formula to express the requisite level of risk exposure while also requiring an inquiry into taxpayer purpose. This particular menu of policy options is problematic largely because the choice must be made in a state of empirical ignorance. It is unclear whether the second and third policy options provide an improvement in target-effectiveness that would warrant the associated administrative and compliance intensity. In this kind of policy environment, maintenance of the status quo tends to be an irresistible policy choice. Nonetheless, there is a much clearer case for the use of a purpose-based standard to backstop the application of risk-based overrides, whether cast as imprecise expressions of risk exposure using standard verbal formulas or more precisely as a percentage amount.