Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Aaron Fennell, MBA, CFA
Portfolio Manager & Investment Advisor
Tel: 416-313-6397
aaron.fennell@rbc.com

RBC Dominion Securities
181 Bay Street, Suite 2350
Toronto, ON M5J 2T3
www.aaronwfennell.com

Taxation of equity-linked notes

In Canada, equity-linked notes (ELNs), sometimes referred to as structured notes, first became popular among conservative investors because they mixed the potential for equity-market returns with the safety of principal usually associated with bonds. ELNs are hybrid securities that can combine equity and debt features into one investable product that allows the investor to participate in the price movement of an underlying asset in a way that's not achievable in a conventional "buy-and-hold" strategy.

Although many investors are familiar with the taxation of traditional investments such as stocks, bonds and mutual funds, the tax treatment of ELNs may not be quite as well known. This article provides a brief overview of what ELNs are and discusses how they are taxed in Canada.

What are ELNs?

ELNs are senior unsecured debt obligations of a financial institution that link the return at maturity and, in some cases, coupon payments to the performance of one or more underlying assets over the term of the obligation. Underlying assets can include equity indices, individual or multiple stocks, commodities, commodity indices, interest rates, currencies, mutual funds or exchange traded funds (ETFs). The payment at maturity is linked to a change in the underlying assets reflecting upside or downside participation, or both.

ELNs may be either principal protected notes (PPNs) or non-principal protected notes (NPPNs). In the case of a PPN, you are guaranteed to receive no less than your original principal amount at maturity. In the case of an NPPN, the investor's original investment is not guaranteed. NPPNs are designed to be alternatives to traditional equities like mutual funds and ETFs.

ELNs can be structured in many different ways. Typically, returns are paid as a single payment at maturity. Some ELNs may make coupon payments over the term of the obligation. These may be: fixed and paid periodically (monthly, semi-annually or annually); variable and linked directly to the return of the underlying asset measured either during regular intervals or over the

term of the ELN, possibly with maximum returns (or "caps") and/or minimum returns (or "floors'); or, paid or not paid based on whether the underlying asset price meets or does not meet one or more pre-determined thresholds.

How are ELNs taxed?

Since ELNs are "prescribed debt obligations," as defined in the Income Tax Act (ITA), the income derived from them (i.e. the return that's based on the increase in the related reference assets or index) is considered to be interest income for tax purposes.

The ITA provides that, for each year you hold the ELN, you are required to include in computing income the amount of interest that's deemed to accrue. The amount of interest deemed to accrue in each taxation year for an ELN is the maximum amount of interest that could be payable in respect of that year. In other words, the full amount of the return on the ELN is included in your income in the taxation year when the return becomes determinable. However, as the return is linked to the performance of one or more reference assets or indices, normally the return can only be determined at or shortly before maturity. As a result, the income inclusion and related tax generally does not occur prior to maturity.

When an ELN is transferred or sold prior to maturity, a specific income tax rule provides that interest accrued to the date of sale is included in the income of the vendor for the year in which the sale occurs. Before 2017, many investors, who held their ELNs as capital property, sold them prior to their maturity date and took the position that no amount in respect of the return on the ELN was accrued interest on the date of sale for the purposes of this specific rule. This allowed these investors to include the full amount of the return on the ELN in the proceeds of disposition and claim the return on the note as a capital gain.

New legislation was introduced in the 2016 federal budget with the intention of ensuring that any positive return on an ELN retains the same character for tax purposes, whether it's earned at maturity or reflected in a secondary market sale. After December 2016, when ELNs held as capital property are sold prior to maturity, all or a portion of any gain realized on the sale of an ELN is to be treated as fully taxable interest income. The gain that is included as accrued interest income is calculated as the difference between two variables: (A) the price for which the ELN was transferred or sold, and (B) the issue price of the ELN less any amount of principal that was repaid by the issuer before the disposition.

There is an exception with respect to foreign currency gains or losses realized on the sale of an ELN if the note is denominated in a foreign currency. Foreign currency fluctuations will be ignored for the purpose of calculating the gain that will be deemed interest income. When calculating the accrued interest income in the case of an ELN that's denominated in a foreign currency, the price for which the ELN was transferred or sold and the issue price (less any principal repaid by the issuer) would have to be converted into Canadian currency using the foreign exchange rate at the time of disposition. Any foreign currency gain or loss realized on the sale would be reported as a capital gain or loss.

Some common examples illustrating the taxation of ELNs

The following examples are simplified and do not reflect the many ways in which an ELN can be structured. All of the examples assume that the principal is protected, except as noted. In addition, the price used in these examples may not be reflective of a true price in the market; the prices used in the examples are to make the calculations simple.

ELN held to maturity

A note with a term of 5 years is issued for $1,000. The return on the note is payable at maturity and is equal to 80% of the performance change in the value of an underlying index between the issue date and the maturity date.

The note is held to its maturity date. At that time, the underlying index has increased 20% in value and the holder receives $1,160. This consists of repayment of the $1,000 principal, plus the return on the ELN of $160 ($1,000 x 20% x 80%).

Therefore, the interest on the note to be reported at the time of maturity is equal to the return on the note of $160.

ELN sold before maturity

A note with a term of 5 years is issued for $1,000. The return on the note is payable at maturity and is equal to 100% of the performance change in the value of the underlying reference assets between the issue date and the maturity date.

The holder sells the note one week prior to its maturity date. At the time of sale, the underlying reference assets have increased 20% in value. The note is sold for a price equal to $1,200.

Therefore, the deemed interest accrued on the note to be reported at the time of sale is $200 ($1,200 – $1,000).

ELN with fixed coupon sold before maturity

A note with a term of 5 years is issued for $1,000. The return on the note is payable at maturity and is equal to 50% of the performance change in the value of

an underlying index between the issue date and the maturity date. The note also provides for an annual fixed coupon payment equal to 2.00% per annum regardless of the performance of the underlying index. The holder sells the note two years prior to its maturity date for a price equal to $1,100.

The annual fixed coupon payment of $20 would be reported as interest income each year when received.

The deemed interest accrued on the note to be reported at the time of sale is $100 ($1,100 – $1,000).

ELN with return of capital sold before maturity

A "return of capital note" with a term of 5 years is issued for $1,000. The return on the note is payable at maturity and is equal to 100% of the performance change in the value of an underlying index between the issue date and the maturity date. The note also provides for an annual partial repayment of 2% of the principal amount of the note (return of capital), which is a repayment of $20 of the principal per year.

The holder sells the note one week prior to its maturity date. At the time of sale, the underlying index has increased 30% in value and the note is sold for a price equal to $1,200. The amount of the principal still outstanding before the sale is equal to $920 ($1,000 – $80, that is 4 × 2% of $1,000).

The deemed interest accrued on the note at the time of sale is equal to $280 ($1,200 – $920).

ELN denominated in foreign currency sold before maturity

A note with a term of 5 years is denominated in U.S. dollars and is issued for US$1,000 when the Canadian dollar is at par with the U.S. dollar. The return on the note is payable at maturity and is equal to 100% of the performance change in the value of an underlying index between the issue date and the maturity date.

The holder sells the note one week prior to its maturity date. At the time of sale, the underlying index has increased 20% in value. At that time, the Canadian dollar has decreased in value and C$1 = US$0.75.

The note is sold for a price equal to US$1,200, which is equal to C$1,600 (US$1,200 converted to Canadian dollars using the foreign exchange rate at the time of the sale – US$1,200/0.75).

To calculate the accrued interest on the sale of the ELN, the issue price of US$1,000 is converted to Canadian dollars using the foreign exchange rate at the time of sale and is equal to C$1,333 (US$1,000/0.75).

Therefore, the deemed interest accrued on the note at the time of sale is equal to C$267 (C$1,600 – C$1,333). To determine if there is also a capital gain or loss on the sale, the proceeds of disposition would be reduced by the amount of the deemed accrued interest to C$1,333 (C$1,600 – C$267). The capital gain is equal to C$333 (C$1,333 – C$1,000).

ELN sold before maturity resulting in capital loss

An NPPN with a term of 5 years is issued for $1,000. The return on the note is payable at maturity and is equal to 100% of the performance change in the value of an underlying index between the issue date and the maturity date.

The holder sells the note 3 years prior to its maturity date. At the time of sale, the underlying index has decreased 20% in value. The note is sold for a price equal to $800.

In this case, there is no deemed interest accrued on the sale of the note, as there is no positive return on the ELN. The deeming provision only applies on the sale of an ELN where there is a positive return. Instead, there would be a capital loss calculated as the proceeds received on the sale of the ELN less the adjusted cost base (ACB) of the note. Therefore, a capital loss of $200 ($800 – $1,000) would be realized at the time of sale.

ELN purchased after issue date and held to maturity

If an ELN is purchased after it's been issued, the purchaser's ACB will typically be equal to the price they paid for the note, which may not necessarily be the principal amount. If the note is held until maturity, there may be a capital gain or loss equal to the principal amount of the note received at maturity less the holder's ACB.

In this example, an ELN with a term of 5 years is issued for $1,000. The return on the note is payable at maturity and is equal to 100% of the performance change in the value of an underlying index between the issue date and the maturity date. At maturity, the underlying index increased 20% in value. The holder of the ELN received $1,200 ($1,000 principal and a return of $200).

If the note was purchased for $900, at maturity, the holder will report a capital gain of $100 ($1,000 – $900). In addition, the holder will report interest income of $200.

ELN purchased after issue date and between coupon interest payment dates

A note with a term of 5 years is issued for $1,000. The return on the note is payable at maturity and is equal to 100% of the performance change in the value of an underlying index between the issue date and the maturity date. The note also provides for an annual fixed coupon payment equal to 2.00% per annum on

June 30 each year, regardless of the performance of the underlying index.

A purchaser acquires the note between coupon interest payment dates on January 1 two years prior to maturity for $1,100 plus accrued coupon interest of $10. In this case, the purchaser's ACB of the ELN would be $1,100. The $10 interest paid to the seller can be deducted against the $20 coupon interest received by the purchaser later that year on June 30. The total amount of interest included in the purchaser's income in the year of purchase would be $10.

The following year, the annual fixed coupon payment of $20 would be reported as interest income.

The note is held to its maturity date. At that time, the underlying index has increased 10% in value and the holder receives $1,010. This consists of repayment of the $1,000 principal plus the return on the ELN of $10 ($1,000 x 10%).

Therefore, the interest on the note to be reported at the time of maturity is equal to the return on the note of $10. However, the holder also has a capital loss at maturity equal to $100 ($1,000 – $1,100).

Tax reporting

When the accrued interest becomes known or determinable, it should be reported to the holder(s) as interest income on a T5, *Statement of Investment Income*. The return on ELNs is commonly only determinable or known at maturity. Therefore, when ELNs are held to maturity, the T5 tax reporting will generally be at maturity. For ELNs that include an annual coupon payment, the coupon payment paid each year would be reported on a T5 annually.

When an ELN is sold prior to maturity, the tax reporting rules require that the sale be reported to the holder of the note (and Canada Revenue Agency) on a T5008, *Statement of Securities Transactions*. The T5008 is required to report the proceeds of disposition less the deemed interest. The deemed interest is reported on a T5 in Box 30. As previously discussed, the deemed interest will include any gain realized (except related to foreign currency) on the sale of the ELN.

Conclusion

ELNs may be structured in many different ways, but generally they combine a fixed-income investment with a potential for returns that are linked to the equity market. For income tax purposes, ELNs are considered debt obligations; therefore, the income derived from them is considered to be interest income. The changes to the taxation of ELNs, effective after 2016, were made to ensure that the return on these debt obligations would be taxed the same way whether the security was held to maturity or sold at an earlier point. This article illustrates the tax consequences of some of the common situations that may arise with ELNs. However, because of the variety of ways an ELN can be structured, you should consult with your RBC advisor and a qualified tax advisor to understand the investment you are making.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.

Wealth Management