Budget 2017: What It Means To The Investment Management Industry

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On March 22, 2017 ("Budget Day"), the Liberal government released its second budget ("Budget 2017"). While Budget 2017 may be known more for the anticipated tax measures that it did not contain rather than the ones that it did, consistent with recent federal budgets, several tax measures were directed at the investment management industry and its investors. It is clear from the government's statements in the budget papers that many of these tax measures were introduced to promote greater consistency and tax neutrality across investment fund vehicles and registered plans. These measures and other tax proposals announced in Budget 2017 that may be of interest to the investment management industry are summarized below.

Switch Corporation Wind-Ups

The Liberal government's first budget in 2016 ("Budget 2016") addressed what it perceived to be unfair tax advantages in multi-class mutual fund corporations or "switch corporations". As a result, effective January 1, 2017, investors in switch corporations are no longer able to exchange or "switch" shares of one class (or mutual fund) for shares of another class (or mutual fund) on a tax-deferred basis. This amendment to the *Income Tax Act* (Canada) (the "Tax Act") eliminated one of the main advantages for taxable investors of investing in a class of a switch corporation versus a mutual fund trust; particularly where similar investment strategies are available to investors in corporate and trust form.

Department of Finance ("Finance") officials have not been amenable to requests from the investment fund industry to permit switch corporations to wind-up individual classes (or mutual funds) that may be less suited to a corporate structure on a tax-deferred basis, or expand the availability of tax-deferred class to class mergers within a switch corporation.1 However, in response to requests from the investment fund industry, Budget 2017 does extend the existing tax-deferred "qualifying exchange" rules that are applicable to mutual fund trust mergers to a complete wind-up of a switch corporation.

In order to meet the proposed new "qualifying exchange" definition, all or substantially all2 of a switch corporation's (the “transferor”) property must be transferred to one or more mutual fund trusts (the "transferees"). This requirement may raise a technical concern for switch corporations that are structured in whole or in part as "fund-of-funds"

since all or substantially all of the property held by the transferor corporation are units of the transferee trusts. In similar trust-on-trust mergers, the Canada Revenue Agency ("CRA") has taken the position that the definition of a "qualifying exchange" will not be met.3 Given the number of switch corporation "fund-on-fund" structures, it is expected that Finance and/or CRA will provide the investment fund industry with some clarity on this issue in the near future.

Another technical issue that may pose challenges is that all of the shareholders of the switch corporation must be redeemed within 60 days following the transfer of all or substantially all of the switch corporation's property to the mutual fund trusts. While this time frame works for mergers of mutual fund trusts, concerns have been expressed by members of the investment fund industry that it may be too short of a period for the wind-up of a large switch corporation given the systems and operational aspects of the mergers.

As is the case with the existing "qualifying exchange" rules, the use of losses of the merging funds will be restricted on the wind-up of the switch corporation. As a result, investment fund managers that are considering taking advantage of this new measure will need to undertake an analysis of the loss carryforward positions of the continuing mutual fund trusts before they proceed with the wind-up of their switch corporation. As a result of this analysis, some switch corporation wind-ups will likely be implemented in two stages with the first stage involving taxable mergers with mutual fund trusts that have significant tax loss carryforward positions.

This measure applies to qualifying exchanges that occur on or after Budget Day.

Segregated Fund Changes

Mutual funds and segregated funds are different legal forms of similar investment products. For many years, both the investment fund industry on behalf of mutual funds and the insurance industry on behalf of segregated funds have advocated for changes that will provide greater consistency in the tax treatment of mutual fund trusts and segregated funds. Budget 2017 includes measures that address some of the tax changes requested by the insurance industry.

A segregated fund is deemed to be a trust for purposes of the Tax Act (referred to as a "related segregated fund trust"). Under the current rules in the Tax Act, a related segregated fund trust is deemed to have made its "income" for the year payable to its beneficiaries so that it is not subject to tax. For taxation years that begin after 2017, it is proposed that the "taxable income" of the related segregated fund trust will instead become payable to beneficiaries. As a result of this measure, segregated funds will now be able to utilize their non-capital loss carry forwards in computing taxable income. Consequential to this amendment, a transitional rule is proposed for taxation years that begin after 2017 that will deem non-capital losses that arose in taxation years that begin before 2018 to be nil.

Budget 2017 also proposes to allow segregated funds to merge on a tax-deferred basis pursuant to new "qualifying transfer" rules that generally parallel the qualifying exchange rules applicable to mutual funds. Under this measure, a "qualifying transfer" will occur at a particular time if *all* of the property that, immediately before the transfer time, was property of a related segregated fund trust (the "transferor") has become, at the transfer

time, the property of another related segregated fund trust (the "transferee"). As with the existing qualifying exchange rules, the use of losses of the merging funds will be restricted following a qualifying transfer.

In order to ensure that the insurance industry has an opportunity to provide comments on these proposed rules, these measures will apply to mergers of segregated funds carried out after 2017 and to non-capital losses arising in taxation years that being after 2017, as described above.

Anti-Avoidance Rules for Registered Plans

Anti-avoidance rules that exist for certain tax-assisted registered plans (i.e., Tax-Free Savings Accounts, Registered Retirement Savings Plans and Registered Retirement Income Funds) will be extended to Registered Education Savings Plans ("RESPs") and Registered Disability Savings Plans ("RDSPs"). These anti-avoidance rules generally include rules which (i) prevent the exploitation of the tax attributes of a registered plan (*i.e.*, by shifting returns from a taxable investment to a registered plan), (ii) ensure that investments held by a registered plan are arm's length "portfolio" investments, and (iii) restrict the classes of investments that may be held by a registered plan. As noted in the budget papers, these tax measures are not expected to have an impact on the vast majority of RESP and RDSP holders, who typically invest in ordinary portfolio investments.

It is worth noting that the amendment of the "qualified investment" rules in respect of RESPs can be viewed as a relieving measure. Under the current rules in the Tax Act, an RESP is subject to revocation if it acquires property that is not a qualified investment, or if property held by it ceases to be a qualified investment and the property is not disposed of within 60 days after that time. These heads of revocation for an RESP will be repealed under this new measure and RESPs will now be subject to the same penalty taxes found in Part XI.01 of the Tax Act applicable to other registered plans that acquire or hold non-qualified investments.4

Subject to the exceptions described below, this measure will apply to transactions occurring, and investments acquired, after Budget Day. For this purpose, investment income generated after Budget Day on previously acquired investments will be considered to be a "transaction occurring" after Budget Day.

The exceptions to this effective date are as follows:

- The advantage rules will not apply to swap transactions undertaken before July 2017. However, swap transactions undertaken to ensure that an RESP or RDSP complies with the new rules by removing an investment that would otherwise be considered a prohibited investment, or an investment which gives rise to an advantage under the new proposals, will be permitted until the end of 2021.
- Subject to certain conditions, a plan holder may elect by April 1, 2018 to pay Part I tax (in lieu of the advantage tax) on distributions of investment income from an investment held on Budget Day that becomes a prohibited investment as a result of this measure.

Timing of Recognition of Gains and Losses on Derivatives

As noted in the budget papers, aside from the mark-to-market property regime applicable to financial institutions there are no specific rules in the Tax Act that govern the timing of the recognition of gains and losses on derivatives held on income account. The following two measures were introduced to provide some clarity to the scheme of the Tax Act in this regard.

Elective use of the mark-to-market method

A recent decision of the Federal Court of Appeal,5 held that a taxpayer that was not a financial institution was entitled to use the mark-to-market method of computing its income from its separate business of speculating on foreign exchange currency options on the basis that it provided an accurate picture of the taxpayer's income. This decision overturned the Tax Court's finding that the taxpayer was required to compute its income on a realization basis for tax purposes (*i.e.*, through the sale or the close-out of the options).

In response to this decision, Budget 2017 introduces an elective mark-to-market regime for "eligible derivatives" held on income account. Once made, the election will remain effective for all subsequent years unless revoked with the consent of the Minister of National Revenue. An eligible derivative for purposes of this new elective regime is defined to mean a swap agreement, a forward purchase or sale agreement, a forward rate agreement, a futures agreement, an option agreement or similar agreement if (a) the agreement is not a capital property, a Canadian resource property, a foreign resource property or an obligation on account of capital of the taxpayer; (b) either (i) the taxpayer has produced audited financial statements prepared in accordance with generally accepted accounting principles in respect of the taxation year, or (ii) the agreement has a readily ascertainable fair market value.6 Once a taxpayer makes the mark-to-market election, the taxpayer will be required to annually include in computing the taxpayer's income the increase or decrease in value of the taxpayer's eligible derivatives. However, the recognition of any accrued gain or loss on an eligible derivative will be deferred until the derivative is disposed of.

This election will be available for taxation years that begin on or after Budget Day.

Straddle Transactions

The second measure aimed at addressing the timing of recognition of gains and losses on derivatives is a new anti-avoidance rule that targets straddle transactions. A straddle transaction is, in simple terms, a transaction whereby the taxpayer simultaneously holds an interest (or position) in two or more financial instruments with the result that equal and offsetting gains and losses are to be generated from the transaction. The measure will effectively defer the realization of any loss on the disposition of a position to the extent the taxpayer has an unrealized gain on an offsetting position. A gain in respect of an offsetting position would generally be unrealized where the offsetting position has not been disposed of and is not subject to mark-to-market taxation.

For the purposes of this measure, a position will generally be defined as including an interest in certain properties (*e.g.*, a traded commodity, a share in a corporation, an interest in a partnership or trust), as well as derivatives and certain debt obligations. An offsetting position with respect to a particular position held by a taxpayer will generally

be a position that has the effect of eliminating all or substantially all[7] of the taxpayer's risk of loss and opportunity for gain or profit in respect of the particular position.

This new measure will not apply to a position held by a mutual fund trust or a mutual fund corporation for purposes of the Tax Act, providing investment funds another incentive to achieve and maintain such status. Other exceptions include a position held by financial institutions (as defined for the purposes of the mark-to-market property rules); a position that is part of certain types of hedging transactions entered into in the ordinary course of the taxpayer's business; or a position that is part of a transaction or a series of transactions none of the main purposes of which is to defer or avoid tax.

This measure will apply to any loss realized on a position entered into on or after Budget Day.

New Compliance Initiatives

As part of Budget 2017, the Liberal government also stated its commitment to implementing stronger standards for corporate and beneficial ownership transparency that provide safeguards against money laundering, terrorist financing, tax evasion and tax avoidance. In particular, the budget papers indicated that the government was examining ways to enhance the tax reporting requirements for trusts in order to improve the collection of beneficial ownership information. As part of these initiatives, amendments to the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* are expected that, amongst other things, support more effective intelligence on beneficial owners of legal entities.

1 Under the current rules in the Tax Act, in order to effect a tax-deferred exchange on a merger of classes (or funds) the old share and the new share must derive their value in the same proportion from the same property or group of properties.

2 The phrase "all or substantially all" in the Tax Act is generally interpreted to mean 90% or more.

3 See CRA Views document no. 9608465, "Mutual fund reorganization", dated September 23, 1996, where the CRA states that in such circumstances "there would not be a disposition where units of the transferee held by the transferor are exchanged by the transferor for identical units of the transferee".

4 RDSPs were already subject to similar penalty taxes. Under this new measure, the non-qualified investment rules that currently apply to RDSPs will simply be moved to Part XI.01 of the Tax Act and existing Part XI of the Tax Act, which currently contains those rules applicable to RDSPs, will be repealed.

5*Kruger Incorporated v. The Queen*, 2016 FCA 186.

6 In the case of agreements held by financial institutions, there is a further requirement that the agreement is not a "tracking property" (as defined in subsection 142.1(1) of the Tax Act) other than an "excluded property" (as defined in subsection 142.1(1) of the Tax Act) of the financial institution.

7*Supra* footnote 2.

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