Mutual Fund Trusts — Revised Proposals Relating to Allocation To Redeemers

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This year's federal budget contained proposed amendments to the *Income Tax Act* (Canada) (Tax Act) that targeted the "allocation to redeemers" methodology used by certain mutual fund trusts and unit trusts (the Budget Proposals). On July 30, 2019, the Department of Finance (Canada) (Finance) released draft legislation that included revisions to the proposed amendments that are relieving in nature, including an industry requested deferral for the exchange traded fund (ETF) industry (the July 2019 Revisions).

Budget Proposals

The Budget Proposals caught many in the investment fund industry by surprise. As the explanatory notes that accompanied the Budget Proposals stated, particularly as it concerned the allocation out of income to a redeeming unitholder, the abuses that Finance were targeting could have been challenged by the government based on existing rules in the Tax Act, in particular subsection 104(7.1). Instead, Finance chose to legislatively codify the allocation to redeemers methodology, which impacted all mutual fund trusts that had the ability to utilize the methodology, to avoid the "time-consuming and costly" challenges that would have resulted from going after the abuses that Finance was targeting. Of note, the Budget Proposals address mutual funds trusts for purposes of the Tax Act. The draft proposals either in their original release, or as recently amended, do not include unit trusts that have not achieved mutual fund trust status. We expect that the reason for this exclusion is that Finance had specific targets in mind when they introduced the Budget Proposals, and those targets were all mutual fund trusts.

In particular, the explanatory notes commented that some mutual fund trusts had been inappropriately using the allocation to redeemers methodology to allocate capital gains to redeeming unitholders in excess of the capital gains that would otherwise be realized by these unitholders on their unit redemptions, resulting in inappropriate tax deferral on the excess amount for remaining unitholders.

Proposed subsection 132(5.3) of the Tax Act was Finance's answer to combat this perceived abuse. This anti-avoidance provision denies a mutual fund trust a deduction

for the excess capital gain allocated to redeeming unitholders over the capital gains the unitholders would have otherwise realized if two conditions are met:

- the amount allocated to the redeeming unitholder is a capital gain; and
- the redeeming unitholder's redemption proceeds are reduced by the allocation.

The Budget Proposals indicated this measure was to apply to taxation years of mutual fund trusts that begin after March 18, 2019. For most mutual fund trusts with December 31 taxation year-ends, these rules would have been applicable on January 1, 2020.

Industry Concerns

Almost immediately, industry members voiced concerns about the restrictive nature of the Budget Proposals. One of the concerns, that does not seem to have been addressed in the July 2019 Revisions is the fact that the inability to allocate out any income to a redeeming unitholder may be a very big concern for new "alternative mutual funds" (colloquially referred to as liquid alt funds). Liquid alt funds represent a hybrid between conventional mutual funds and privately offered hedge funds and are subject to somewhat relaxed investment restrictions. In particular, liquid alt funds and non-redeemable investment funds are now permitted to borrow up to 50 per cent of the fund's net asset value, subject to certain conditions. This leverage can be achieved through cash borrowing, short-selling and specified derivative transactions. The increased use of derivatives is expected to cause such funds to realize much more gains and losses on income versus capital account than traditional retail mutual funds. Industry members voiced concerns to Finance that under this new regulatory environment, the inability to allocate out ordinary income to redeeming unitholders may cause significant investor unfairness, particularly in circumstances where a large redemption by a unitholder will necessitate an early close-out of a derivative held on income account to fund the redemption proceeds. Making a special distribution in advance of such a redemption may not be a practical way to address the concern that remaining unitholders could bear all of the consequences of the disposition of the derivative.

Another concern addressed to Finance is that mutual funds trusts do not often have precise information on individuals' adjusted cost bases. As a result, to the extent that mutual fund trusts were utilizing the allocation to redeemers methodology, many of them were making "best guesses" at this amount or utilizing cost numbers to perform the allocation out of capital gains to redeeming unitholders.

Finally, Finance heard the concern that the Budget Proposals, if enacted as proposed, would make the methodology impracticable for most listed mutual fund trusts, particularly those in the ETF space, where redemptions are likely to be requested only by market makers that generally have a cost amount that is equal to the fair market value of their units.

Stakeholders in the investment fund industry voiced these concerns to Finance combined with submissions on the well-known inadequacies of the capital gains refund mechanism, which the allocation out to redeemers methodology is meant to address. As noted above, for the most part, the July 2019 Revisions are a welcome response to relief sought by the investment fund industry (although not a permanent solution).

July 30 Revisions

The July 2019 Revisions contain two changes to the Draft Proposals.

Determining a Beneficiary's "Cost Amount"

First, the July 2019 Revisions attempt to resolve concerns surrounding a mutual fund trust's ability to track the adjusted cost base of a redeeming unitholder's units. A trustee of a mutual fund trust is now only required to use "reasonable efforts" to determine the "cost amount" of units held by a redeeming unitholder.

In order to meet these "reasonable efforts", Finance has stated:

Generally, it is expected that a mutual fund trust will keep records of initial subscription prices paid when units are acquired and will have accurate information as to transactions involving the units to which the MFT is a party, that may affect the cost amount of the units. In the absence of such information, it is expected that the mutual fund trust would make reasonable efforts to obtain this information, for example through inquiries to third parties or through a search of relevant records.

It would not be expected that a mutual fund trust would need to make inquires regarding external factors (*i.e.*, events that did not involve the mutual fund trust or transactions to which the mutual fund trust was not a party) unless the mutual fund trust has reason to believe that such external factors exist and could affect the cost amount of the units.

This concession will significantly decrease the compliance burden that would have been associated with tracking the adjusted cost base of mutual fund trust units, thereby ensuring that the allocation out to redeemers methodology is still a valid approach in the toolkit of non-listed mutual fund trusts to ensure unitholder fairness

Deferred Coming into Force Date

The second very welcomed change to subsection 132(5.3) is a deferral of the application of 132(5.3)(b) to mutual fund trusts that have units that are (i) listed on a designated stock exchange in Canada; and (ii) are in continuous distribution. Based on its wording, the deferral will also apply to mutual fund trusts that have ETF series or platform series. Instead of the rules applying to taxation years of such mutual fund trusts that begin after March 18, 2019, paragraph 135(5.3)(b) is now proposed to apply in respect of taxation years beginning after March 19, 2020. Paragraph 132(5.3)(b) will continue to apply to all other mutual fund trusts for taxation years beginning after March 18, 2019. This second change was largely to address the concerns of the ETF industry most recently voiced in a joint submission to Finance from the Investment Funds Institute of Canada (IFIC) and the Canadian ETF Association (CETFA). The deferral will give the ETF industry additional time to engage with Finance about possible improvements to the capital gains refund mechanism and other possible solutions that will ensure that Canadian ETF issuers remain competitive with their non-listed Canadian mutual fund trust counterparts. It is also hoped that Finance will consider the approaches of other international jurisdictions to help find a Canada-made solution for

investor fairness that increases the investment fund industry's international competitiveness.

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