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Introduction

This is the second edition of KPMG’s Asset Management Tax Handbook. This book is intended for business professionals and others with an interest in Canada’s asset management industry. It outlines recent and significant provisions of Canada’s federal income tax legislation applicable to domestic and foreign investment management activities.

As the competition for capital allocation intensifies, commercial relationships are becoming more important than ever in the asset management industry. Whether directly with clients, or through intermediaries, the trust-based relationship that exists between investor and fund manager is critical to commercial success. There was however general agreement that the industry is at a crossroads, and the winners will be those who focus on recruiting better people, designing and implementing better customer processes, and utilizing better technology to deliver the easiest, hassle-free experience at lowest cost. Tax risk governance and tax efficiency are an integral part of enhancing commercial relationships in the asset management industry. Increasingly, asset managers are highlighting the tax-efficient design of their products as a differentiator in order to enhance the client experience.

With tax reform happening in Canada and other parts of the world, tax risk and efficiency concerns amongst investors has never been greater, as in many cases existing structures or previously relied upon tax assessing practices have changed substantially and thus give rise to tax leakage. Asset managers and service providers have been proactive embracing technology in their investment strategy, regulatory and distribution models. Digital automation in tax compliance and reporting is no exception as the industry re-engineers itself to become the tax department of the future to streamline processes and automate tasks to increase productivity, heighten accuracy and lower costs.

We have prepared KPMG’s Asset Management Tax Handbook with the most up-to-date tax developments to provide industry participants with a useful tax technical resource to help navigate through some of the tax fundamentals regularly faced by asset managers in order to help investment funds succeed in today’s constantly changing environment. We hope that this book assists tax departments in their endeavour to understand the embedded risks in the ever-changing tax policy landscape in order to make more informed decisions on day-to-day operations, as well as channelling it proactively and positively to create real value for investors.

We trust that this book will be a helpful summary of the main features of our current asset management tax regime, both to readers who intend to undertake asset management activities in Canada and to readers who wish to establish asset management operations in Canada. We also hope that it will be a useful guide in everyday dealings with taxation matters affecting the industry.

Readers who require further information or assistance are invited to contact Joseph Micallef or any of KPMG’s asset management professionals.

Statements of law in this book are current to July 31, 2017.

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Investment structures
Mutual fund trusts

Mutual funds are commonly structured as trusts. From a legal point of view, a trust is a relationship in which a trustee holds property for the benefit of beneficiaries. In the investment fund industry, a mutual fund trust (“MFT”) is formed by declaration of trust; the fund manager or professional trustee becomes the trustee and settles the trust with a nominal amount. Investors are invited to participate in the trust through a prospectus or offering memorandum.

The Income Tax Act, Canada (“the Act”) treats a trust as a separate taxpayer and as an individual. An MFT is subject to the highest personal tax rate on income retained in the trust. The Act permits a trust to flow the income out to its beneficiaries, and the income designated to the beneficiaries retains its characteristics for tax purposes. Certain tax advantages of the Act make the MFT a suitable vehicle for a variety of investors.

Benefits of MFTs

There are several benefits of attaining MFT status:

- **Non-application of alternative minimum tax (“AMT”).** A trust that is an MFT throughout the year is exempt from the AMT. Without this exception, a trust could be subject to AMT even if it distributes all income and net realized capital gains to its beneficiaries.

- **Non-application of the Act, part XII.2 taxes.** A trust that is an MFT throughout the year is exempt from the Part XII.2 taxes. Part XII.2 taxes apply to “designated income” of a trust if it has “designated beneficiaries.” Part XII.2 imposes a special tax on unitholders who are non-residents, or tax exempt.

- **Election for December 15 tax year-end.** An MFT can elect a December 15 year-end to enable distributions to its unitholders by December 31. This election can be revoked at a later time.

- **Eligibility for capital gain refund mechanism (“CGRM”).** An MFT can benefit from the capital gain refund mechanism and retain a certain amount of net realized capital gains in the fund without paying taxes, based on a formula. The details of this rule can be found in the section **Capital gain refund mechanism.**
Non-application of mark-to-market rule ("MTM rule"). Financial institutions ("FIs") are generally subject to the MTM rule in the Act. An MFT is excluded from the definition of FIs and, therefore, the MTM rule does not apply.

Qualified investments for registered plans. MFT units are automatically qualified as investments for registered plans such as Registered Retirement Savings Plans ("RRSPs"), Registered Retirement Income Funds ("RRIFs"), Tax-Free Savings Accounts ("TFSAs") and Registered Education Savings Plans ("RESPs").

Qualified for the 39(4) election. MFT units are qualified as Canadian securities for the purposes of the 39(4) election.

Non-application of the T1135 foreign income verification statement filing (T1135). An MFT is exempted from the T1135 filing.

Meaning of MFT

The meaning of MFT is defined by the Act. In very general terms, a trust must meet three conditions to become and remain an MFT:

1. The trust must be a unit trust resident in Canada.
2. The undertakings of the trust are restricted to certain investing activities.
3. The trust must comply with prescribed conditions.

The details of these three conditions are explained below.

Unit trust

There are two types of unit trusts, the open-ended trust and closed-ended trust. Both types of unit trusts are required to be inter vivos trusts, and the interest of each beneficiary is described by reference to units of the trust.

In order for a trust to meet the definition of an open-ended unit trust under the Act, it must meet the following requirements:

- At least 95% of the fair market value ("FMV") of all issued units of the trust are units that are redeemable at the demand of the holder. Open-ended trusts provide their investors with liquidity and flexibility to dispose of their units. In practice, the redemption feature typically contains certain restrictions in terms of frequency and valuation.

By comparison, a closed-ended unit trust does not require its units to be redeemable. Instead, it contains several restrictions:

- Its only undertaking is the investing of its funds in property (other than real property or an interest in real property) or the acquiring, leasing or managing of any real property or interest in real property that is capital property to the trust, or a combination of both.
- At least 80% of the trust’s property consists of any combination of properties that are listed by the Act, such as shares, bonds, cash and marketable securities, among other things.
- At least 95% of the income for the year was derived from the permitted investing properties or the disposition of those properties.
- At no time in the year does it hold more than 10% in securities other than Her Majesty in Right of Canada or a province or a Canadian municipality.

Prescribed conditions

Regulation 4801 prescribes certain conditions to be qualified as an MFT:

- A class of units of the trust is “qualified for distribution to the public,” or a trust has made a lawful distribution to the public of units of the trust in a province where a prospectus, registration statement, or similar document was not required to be filed under the province’s laws in respect of the distribution.
- There are at least 150 beneficiaries of the trust, each of whom holds at least one “block” of units of the class, and units of that class that have an aggregate FMV of at least $500.

A “block of units” is further defined by Regulation 4803(1) as

- 100 units if the FMV of one unit of the class is less than $25
- 25 units if the FMV of one unit of the class is $25 or more but less than $100
- 10 units if the FMV of one unit of the class is $100 or more
Election to be an MFT

It is inevitable that a trust fund will not meet the 150-unitholder requirement at its inception. However, as long as the trust fund is able to meet the 150-unitholder requirement no later than 90 days after its first tax year-end (assuming all other conditions have been met) the Act provides an election for a trust fund to make when it files its first-year trust income tax return to deem that the trust fund has been an MFT since inception. This election permits a new trust to take advantage of certain benefits provided by the Act that typically require a trust to be an MFT throughout the year.

Compliance requirements

Each MFT is required to file a T3 Trust Income Tax and Information Return (“T3 Return”) annually. The filing deadline for a T3 Return is no later than 90 days after the MFT’s tax year-end.

In addition to the annual T3 Return, an MFT may be required to file other returns and related slips depending on the situations as described below:

- If an MFT made distributions during the year, it is required to file the related T3 slips together with the T3 return, as well as an NR4 summary and NR4 slips if there were distributions to non-resident unitholders.
- If an MFT had subscriptions and redemptions for RRSP and RRIF accounts, the fund is required to issue RRSP contribution slips, T4RRSP slips and T4RIF slips.
- A T3F – Investments Prescribed to be Qualified Information Return is required to be filed annually.
- Form T123 – Election on Disposition of Canadian Securities under subsection 39(4) of the Act need only be filed once.
- Election to be an MFT under subsection 132(6.1) of the Act is only applicable to a first-year MFT.
Mutual fund corporation

A mutual fund corporation ("MFC") is a single legal entity offering multiple classes of shares that track the performance of separate investment portfolios. An MFC is able to elect that certain dividends paid to investors are taxed as capital gains from the disposition of property. To avoid double taxation at the investor and corporate level, the Income Tax Act, Canada ("the Act") also provides a capital gain refund mechanism ("CGRM") similar to that provided for a mutual fund trust. See section on Capital Gain Refund Mechanism.

While an MFC is regarded as a public corporation, it is treated as a private corporation for purposes of Part IV tax and dividend tax refunds.

Meaning of MFC

For tax purposes, an MFC is a corporation that at any time during a taxation year was either a prescribed labour-sponsored venture capital corporation, or a Canadian public corporation that meets certain criteria.\(^1\)

A "public corporation" is a corporation that either has a class of its shares listed on a designated stock exchange in Canada, or has previously elected in prescribed manner to be treated, for tax purposes, as a public corporation and meets certain prescribed conditions.\(^2,3\)

The criteria for a Canadian public corporation to be an MFC for tax purposes are:

- Its sole undertakings are
  - a. Investing its funds in property (other than real or immovable property)
  - b. Acquiring, holding, maintaining, improving, leasing or managing any real or immovable property that is capital property of the corporation, or
  - c. Any combination of a) and b)
- The issued shares of the capital stock of the corporation include shares that:
  - a. Have conditions attached to them requiring the corporation to accept, at the demand of the holder and at prices determined and payable in accordance with the conditions, the surrender of the shares (or fractions or parts of them) that are fully paid, or
b. Qualify in accordance with prescribed conditions relating to the redemption of the shares, and

c. The fair market value of the shares described above is at least 95% of the fair market value of all the issued shares of the corporation's capital stock (such fair market values being determined without regard to any voting rights attaching to the shares).4

A corporation is not an MFC if it can reasonably be considered, with regard to all circumstances including the terms and conditions of the shares of its capital stock, that it was established or is maintained primarily for the benefit of non-resident persons, unless it meets one of two exceptions:

1. All or substantially all of the corporation's property consisted of property other than taxable Canadian property (excluding certain property such as property used in respect of an insurance business being carried on in Canada, or ships and aircraft used in international travel).

2. The corporation has not issued a share (other than by a stock dividend) to a person who, after reasonable inquiry, it had reason to believe was a non-resident.5

Capital gains dividends refund mechanism (CGRM)

Capital gains dividends
An MFC may elect in prescribed form (see Form T2055, Election in Respect of a Capital Gains Dividend under compliance requirements below) to distribute a dividend deemed to be a capital gains dividend to the extent the dividend amount does not exceed the corporation's capital gains dividend account. A capital gains dividend is deemed to have been received by a taxpayer as a capital gain from the disposition of property for purposes of computing taxable income. The taxpayer is deemed not to have received a dividend.

An MFC’s capital gains dividend account is determined by a formula generally including capital gains realized by the corporation less capital losses and capital gains dividends previously paid.

Penalties on excessive elections
Where an amount has been elected as a capital gains dividend in excess of the capital gains dividend account, the MFC (jointly with the recipients of the capital gains dividend6) are liable to pay tax equal to 3/5th of the excess.7

Where an excessive election has been made, an MFC may elect that the excess amount be treated as a taxable dividend. The election to have the excess treated as a taxable dividend must be filed in prescribed manner within 90 days of the date of a notice of assessment in respect of the tax otherwise payable. In order for this election to be valid, the corporation and all shareholders who received any portion of the dividend must agree to make the election. Shareholders who previously received capital gains dividends may have taxes owing as a result of the election, including interest on unpaid balances, and therefore may not concur with the election.8

Taxable Canadian Property (TCP) gains distribution9
To the extent that an MFC has a TCP gains balance (i.e., net capital gains from the disposition of TCP) and more than 5% of a capital gains dividend is received by a non-resident person or partnership, each shareholder receiving the capital gains dividend is deemed to receive a TCP distribution for purposes of income and withholding tax.10

The amount of each shareholder’s TCP distribution will be equal to the lesser of the amount paid and the shareholder’s pro rata share of the TCP gains balance.

The TCP distribution that is received by a non-resident is deemed to be a taxable dividend and not a capital gains dividends. As a result, withholding tax rates on dividends will be applicable to capital gains dividends paid to non-residents, to the extent that these are TCP distributions. Treaty rates applicable to capital gains are not applicable to these under most tax treaties capital gains from the disposition of TCP generally does not apply.

Capital gains refund mechanism
An MFC is entitled to a capital gains refund equal to the lesser of refundable capital gains tax on hand at the end of the year and an amount determined by formula based on capital gains dividends paid by the corporation.11 To be eligible for this refund, an income tax return must be filed within three years of the year to which the refund relates.
The capital gains refund can be applied by the Minister against any other payment due by the MFC. Generally, the amount of capital gains dividends paid in the year will be determined such that the capital gains refund will be equal to the refundable capital gains tax on hand, and no amount is payable or receivable.

“Fund switching” and the 2016 federal budget

Traditionally, one of the benefits of an MFC was the ability to switch from one class of shares to another class of shares on a tax-deferred basis where no other consideration was received by the investor. This rollover allowed investors to change the composition of their investment portfolios without realizing a taxable disposition, since different classes of shares generally track the performance of a particular basket of securities.

The 2016 federal budget amended legislations to treat such switches of shares as a taxable disposition at fair market value. The budget includes an exception to the new measures for switches when the classes that are switched differ only in respect of management fees or expenses to be borne by investors. This measure applies to exchanges between share classes that occur after January 1, 2017.

Merger rules for mutual fund corporations

As a result of industry requests following the elimination of a taxpayer’s ability to obtain tax deferred fund switching, the 2017 Federal budget has proposed to expand the merger rules under Section 132.2 of the Act to facilitate the tax-deferred reorganization of mutual fund corporations organized as switch funds. Under the proposed rules, a mutual fund corporation will be able to restructure itself into multiple mutual fund trusts on a tax-deferred basis, provided that there is a qualifying exchange. A qualifying exchange is defined as a transfer at any time where:

- All or substantially all of the property of the mutual fund corporation (other than a SIFT wind-up corporation) is transferred to one or more mutual fund trusts.
- All or substantially all of the shares issued by the mutual fund corporation and outstanding immediately before the transfer time are disposed of to the transferor within 60 days after the transfer time.
- No consideration for the shares is received other than units of one or more mutual fund trusts arising from the reorganization.
- If the property of the transferor has been transferred to more than one transferee, all shares of each class of shares are disposed of to the transferor within 60 days after the transfer time.

- The units received in consideration for a particular share of a class of shares of the transferor are units of the transferee that received all or substantially all of the assets that were allocated to that investment fund immediately before the transfer time.

A joint election must be made in prescribed form with the Minister of Revenue on or before the election's due date. The election due date is proposed to be the later of six months after the transfer date or a date as specified by the Minister. This measure will apply to qualifying reorganizations that occur on or after March 22, 2017.

Although for a limited few, these expanded rules offer some relief for those managers who wish to terminate their mutual fund corporation entirely; however, it still does not go far enough for the industry as a whole. It should be highlighted that mutual fund corporations still have a number of significant advantages for investors and investment managers are not inclined to terminate these structures in their entirety. Industry participants still continue to request Finance to consider single class fund spin-outs on a tax-free basis to a mutual fund trust as well as class to class tax deferred mergers.

Part IV tax

Generally, an MFC is deemed to be a private corporation for purposes of the dividend refund mechanism and Part IV Tax on Taxable Dividends Received by Private Corporations. An MFC that is not an investment corporation is required to pay tax equal to 38.33% of taxable dividends received in the year. This amount is added to the MFC’s refundable dividend tax on hand (“RDTOH”) balance, which is refunded as the MFC pays dividends to shareholders. The amount of RDTOH refunded is equal to 38.33% of dividends paid by the MFC.

Other

Exclusion from deemed dividend rules on wind-up

An MFC is not deemed to have paid a dividend to shareholders where it otherwise would be under section 84 of the Act, including in the case of a distribution on wind-up or redemption. A prescribed labour-sponsored venture capital corporation may elect to have subsection 84(1) of the Act apply (i.e., a dividend is deemed to be paid to shareholders in certain circumstances where paid-up capital increases).
Election to not be a restricted financial institution (RFI)
Where an MFC otherwise meets the definition of a restricted financial institution for purposes of the Income Tax Act, an election in prescribed form may be made to deem the MFC to not be a restricted financial institution. This election has implications for the application of rules for dividends received on term-preferred shares (T2143 Election not to be a restricted financial institution).

Specified debt obligations and mark-to-market rules not applicable
The specified debt obligations and mark-to-market rules provide special rules for computing taxable investment income for financial institutions. For purposes of these rules, an MFC is excluded from the definition of “financial institution.” Therefore, the obligations and rules are not applicable regardless of any other definitions in the Act.

Compliance requirements
T2 corporate income tax return
An MFC must file a T2 Corporate Income Tax Return within the period that ends six months after the tax year-end.

T2073 election to be a public corporation
An MFC is required to file this election by the filing due date of its first corporate income tax return.

T2055 election in respect of a capital gains dividend under subsection 131(1)
An election to treat a dividend as a capital gains dividend must be made using form T2055 before the time that is the earlier of the time the dividend becomes payable and the first day on which any part of the dividend is paid.

A late election may be filed subject to penalties equal to the lesser of:
- 1% per year of the amount of the dividend that is elected to be a capital gains dividend for each month (or parts of a month) during the period between the applicable due date and the date the election is made
- $500 times the number of months (or parts of a month) described above divided by 12.

Distributions to non-residents
Generally, dividends paid by a Canada resident corporation to a non-resident are subject to 25% withholding tax. However, this rate is often reduced by an applicable treaty (e.g., the Canada-U.S. tax treaty limits the dividend withholding tax to 5-15% depending on the ownership interest of the non-resident in the Canadian corporation). Withholding tax is not applicable to a capital gains dividend paid by an MFC unless the capital gains dividend is a TCP distribution. A TCP distribution is subject to dividend withholding tax rules and treaty benefits (not capital gains clauses of a treaty).

An NR4 Statement of Amounts Paid or Credited to Non-Residents of Canada must be filed in respect of payments made to non-residents (including dividends) and amounts withheld. The NR4 return is due March 31 in respect of the preceding calendar year.

1 Income Tax Act (Canada) Subsection 131(8)
2 Ibid, Subsection 89(1)
3 Per Regulation 4800(1) of the Income Tax Regulations, to elect to be a public corporation, at the time of the election, the corporation must have:
   - A class of shares designated in its election shall be qualified for distribution to the public;
   - No fewer than 150 shareholders where the class of shares is equity shares, or 300 shareholders in other cases, other than insiders of the corporation each of whom hold not less than one block of that class shares having an aggregate fair market value of not less than $500; and
   - Insiders of the corporation shall not hold more than 80 per cent of the issued and outstanding shares of that class of shares.
4 Income Tax Act (Canada) Subsection 131(8)
5 Ibid, Subsection 131(1.1)
6 Ibid, Subsection 185(4)
7 Ibid, Subsection 184(2)
8 Ibid, Subsection 184(4)
9 Ibid, Subsection 131(6.1)
10 Income Tax Act (Canada) Subsections 131(5.1) and 131(6.2)
11 Ibid, Subsection 131(2)
12 Ibid, Subsection 131(3)
13 Ibid, Subsection 51(1) and CRA VIEWS 2000-0050265
14 Ibid, Subsection 131(5)
15 Increased from 1/3 as a result of the 2015 Federal budget for years that end after 2015 (prorated for years that begin before 2016 and end after 2015)
16 Ibid, Subsection 186(1)
17 Income Tax Act (Canada) Subsection 129(1)
18 Ibid, Subsection 131(4)
19 Ibid, Subsection 131(11)
20 Ibid, Subsection 131(10)
21 Ibid, Subsection 142.2(1)
22 Income Tax Act (Canada) Subsection 131(1.3)
23 Ibid, Subsection 212(2)
24 Ibid, Section 202
Limited partnership

Most private equity, infrastructure, and hedge funds in Canada are structured as limited partnerships. The partnership may be formed under the partnership law of one of the provinces, or of another jurisdiction. Typically, the choice of jurisdiction is often dictated by commercial (non-tax) reasons, including investors’ familiarity with the laws of a particular jurisdiction.

A limited partnership is a legal arrangement that constitutes a partnership under common law. A limited partnership must have at least one general partner and at least one limited partner. In the fund industry, investors contribute capital in exchange for limited partnership interests. To be offered limited liability with respect to their investment, the role of limited partners is generally restricted to contribution of capital. Limited partners are not involved in the day-to-day activities of the fund. The general partner (typically the fund sponsor or a subsidiary or affiliated entity of the fund sponsor) is responsible for carrying out the activities of the fund, and is typically the only partner permitted to undertake those activities. The general partner’s liability with respect to the debts and obligations of the partnership is unlimited.

A partnership is not a person, nor is deemed to be one for the purposes of the Income Tax Act, Canada (“the Act”). The intention of the Act is to treat a partnership as a conduit or flow-through vehicle (with the exception of Specified Investment Flow-Through (“SIFT”) partnerships that are taxed at the partnership level) provided that, in order to determine the income (or loss) of a member of a partnership, the income (or loss) of the partnership from various sources or activities should be computed as if the partnership were a separate person resident in Canada. The partnership’s income from those sources or activities is then allocated to the partners, to be included in their incomes according to the terms of the relevant partnership agreement regardless of actual distributions. The income (or loss) allocated to the partners maintains its character.

Although the Act does not contain any specific provisions prescribing how income (or loss) is to be allocated to partners, it contains two provisions that grant the Minister of Finance (“Minister”) the discretion to challenge allocations if they are unreasonable. If the principal reason for the agreed upon allocation of partnership income (or loss) can reasonably be considered to be the reduction or deferral of tax, a revised income allocation from the Minister that is reasonable considering all relevant circumstances might apply instead. In addition, where the partners do not deal at arm’s length with each other, the Minister has the discretionary power to reallocate the partnership’s income (or loss) in a manner that is reasonable considering capital invested or work performed by the partners.
Adjusted cost base of a partnership interest

In addition to the allocated income (or loss) noted above, taxation of a partnership includes any gain or loss determined on disposition or redemption of the partnership interest. Partnership interest that is held by a partner as a capital property results in a capital gain (or loss) on disposition or redemption based on the difference between the proceeds of the disposition ("POD") and adjusted cost base ("ACB"). It is worth noting the CRA has stated that a taxpayer’s interest in a limited partnership is considered to be one capital property. Consequently, each unit of partnership interest, which is commonly used in the fund industry, should not have a separate ACB within the meaning of the Act. Generally, a partner’s ACB is that partner’s original contribution on acquisition of the partnership interest adjusted for additions and deductions outlined under paragraphs 53(1)(e) and 53(2)(c) of the acts respectively. The following outlines examples of some common ACB adjustments applicable to investors in the fund industry:

Additions in Computing ACB:

- The partner’s share of income of the partnership from all sources for each completed fiscal period of the partnership before the particular time;
- The partner’s share of capital dividends and any life insurance capital dividends received by the partnership before the particular time;
- Any contribution of capital made to the partnership before the particular time;
- The amount of any capital gain realized in cases where the existence of negative ACB in the partnership interest deems such a gain to arise.

Deductions in Computing ACB:

- The partner’s share of the losses of the partnership from all sources for each completed fiscal period of the partnership before the particular time;
- The partner’s share of any limited partnership loss in respect of the partnership for a fiscal period ending before that time, but only to the extent that such loss has been deducted in computing the taxpayer’s income for any taxation year that commences before the particular time;
- The amount of loss that a partner has elected to recognize under subsection 40(3.12) in order to offset a gain previously recognized on a negative ACB;
- The partner’s share of resource expenditures of the partnership incurred in fiscal periods of the partnership ending prior to that particular time and any amount received before the particular time that is a distribution of the partner’s share of the partnership profits or partnership capital.

For limited partners or specified members of the partnership, a capital gain will arise when the ACB of their partnership interest becomes negative.

At-risk amount

Limited partners of a partnership are limited in their capacity to deduct any loss of the partnership that has been allocated to them to the extent of their at-risk amount ("ARA") as at the end of the fiscal period of the partnership ending in that year. To the extent that an allocated loss cannot be deducted in a particular taxation year, the loss is deemed to be the limited partner’s “limited partnership loss” that can be carried forward indefinitely and deducted in future years to the extent the partner’s “ARA” has increased.

Generally, the partner’s ARA is calculated as the partner’s ACB of the partnership interest plus the partner’s share of the current year’s income from the partnership, minus all amounts owing by the partner to the partnership and any amount or benefits to which the partner is entitled.

Qualified investment status

Partnership units that are listed on designated stock exchanges are qualified investments for TFSAs, RRSPs, RRIFs, RESPs, Registered Disability Savings Plans ("RDSPs") and Deferred Profit Sharing Plans ("DPSPs").

Compliance requirements

Filing requirements and deadline

All limited partnerships that carry on a business in Canada or are Canadian partnerships or are considered to be a Specified Investment Flow-Through Tax ("SIFT") partnership must file an annual T5013 partnership information return, with some administrative exceptions. T5013 slips prepared in conjunction with the T5013 partnership information return are then provided to individual partners so they can report their share of partnership income or loss on their income tax returns.
The due date for filing the annual information return (including distributing the T5013 slips) depends on the type of partners, including end members of a tiered partnership. If all partners of the partnership are individuals, including end members of tiered partnerships, the filing deadline for the partnership is March 31st. If all of the partners of the partnership are corporations, including end members of tiered partnerships, the filing deadline for the partnership is five months after the end of the partnership’s fiscal period. In any other case, the filing deadline is the earlier of March 31st after the calendar year in which the fiscal period of the partnership ended, and the day that is five months after the end of the partnership’s fiscal period.

Compliance requirements

Limited partnerships are also required to consider the following foreign reporting compliance requirements where applicable:

- T1134 – for investments in controlled or non-controlled foreign affiliates
- T1135 – for investments in specified foreign property exceeding $100,000
- T1141 – for transfers or loans to non-resident trusts
- T1142 – for distributions from and indebtedness to non-resident trusts
Investment corporations

Certain types of Canadian public corporations may be defined as “investment corporations” for Canadian federal income tax purposes, where the corporation meets several requirements (as described below). The benefit of being an investment corporation throughout a taxation year is that the corporation will be allowed a 20% deduction in respect of the amount by which its taxable income exceeds its taxable capital gains for the year.\(^43\)

The purpose of this deduction is to recognize that investment corporations are flow-through vehicles generally required to distribute substantially all of their income, other than taxable capital gains, to shareholders in the year in which the income is earned.\(^46\)

### Meaning of investment corporation

A corporation is an investment corporation for Canadian federal income tax purposes where it has complied with the following conditions:\(^46\)

1. It was a Canadian corporation that was a public corporation throughout the year;
2. At least 80% of its property throughout the year consisted of shares, bonds, marketable securities, or cash;
3. At least 95% of its income for the year was derived from shares, bonds, marketable securities, or cash;
4. At least 85% of its gross revenue for the year was from sources in Canada;
5. No more than 25% of its gross revenue for the year was from interest;
6. At no time in the year did more than 10% of the property held by the corporation consist of shares, bonds, or securities of any one corporation or debtor other than a Canadian federal, provincial, or municipal security;
7. No person (referred to as a “specified shareholder”) holds greater than 25% of any class of the shares of the capital stock of the corporation (including shares held by related persons);
8. At least 85% of the total of the following forms of income, less any dividends or interest received by it in the form of shares, bonds, or other securities held at the end of the year, were distributed, otherwise than by way of capital gains dividends, to shareholders before the end of the year:

a. Two-thirds of the amount by which taxable income for the year exceeds taxed capital gains, and

b. The amount by which all taxable dividends received by it in the year (to the extent such amounts were deductible under Section 112 or 113) exceeds the amount that the corporation’s non-capital loss for the year would be if taxable capital gains for the year were nil.

**Benefit of an investment corporation**

Generally, being regarded as an investment corporation for Canadian federal income tax purposes results in the following:

1. The federal tax rate in respect of investment income (other than taxable capital gains and taxable dividends from Canadian corporations) is subject to a 20% reduction. As such, an investment corporation is taxable on this income at a rate of roughly 8%.

2. Taxable capital gains will be taxed at the full corporate tax rate on investment income. However, this tax is refundable to the extent that the corporation pays a dividend, see section on capital gains refund mechanism.\(^{47}\)

3. Share redemptions by an investment corporation may be deemed to be dividends in accordance with the general rules contained in section 84. Mutual fund corporations are exempted from these deeming rules.

Note that a mutual fund corporation (“MFC”) may also be defined as an “investment corporation” in a given taxation year. The benefit of being defined as an investment corporation is that the Part IV tax would not apply to the MFC in respect of its portfolio dividend income.\(^{48}\)

\(^{43}\) NTD: Per the Act this is technically “taxed capital gains” which is defined as taxable capital gains for the year adjusted for certain amounts in respect of losses. In an effort to simplify, we have opted to refer to these gains as “taxable capital gains.”

\(^{44}\) Income Tax Act (Canada) Subsection 130(1)

\(^{45}\) 2013 Department of Finance Technical Notes, 5th Edition, Section 130

\(^{46}\) Income Tax Act (Canada) Subsection 130(3)(a)

\(^{47}\) Income Tax Act (Canada) Subsection 130(2) and Subsection 131(2)

\(^{48}\) Ibid, Subsection 131(5)
Registered investments

Qualified investments

Trusts that are governed by a deferred income plan (i.e., Registered Retirement Savings Plan (“RRSP”), Registered Retirement Income Fund (“RRIF”), and Deferred Profit Sharing Plan (“DPSP”)) are restricted to investing in certain types of properties referred to as “qualified investments.”\(^{49}\) Note that a trust governed by a deferred income plan that invests in any non-qualified investments will be subject to penalty taxes as described later in this section.

Subject to certain restrictions, the types of property that are considered qualified investments\(^{50}\) are:

- Money and deposits
- Certain debt obligations
- Publicly traded securities (other than futures or derivatives)
- Certain Guaranteed Investment Certificates (“GICs”)
- Certain investment contracts
- Prescribed investments

Prescribed investments are defined by regulation as including a variety of securities and investments including unit trusts and corporations that have qualifying mutual fund status under the Income Tax Act, Canada (“the Act”). In addition, prescribed investments include investments in registered investments, which are a form of pooled investments that may not have met some of the requirements to be a mutual fund under the Act.\(^{51}\)
Registered investments

A Registered Investment ("RI") is a trust or corporation that has applied to be, and has been approved by the Minister of Finance as, an acceptable investment to be held by an RRSP, RRIF, or DPSP. Where a non-RI is held by a deferred income plan, the plan will be subject to a penalty tax as described later in this section.

What are the requirements?

A trust or corporation may be accepted as an RI by the Canada Revenue Agency ("CRA") when it meets one of the conditions outlined in paragraphs 204.4(2)(a) to (f) of the Act. Essentially, each of these conditions permits the CRA to accept the trust or corporation as an RI under one of three main categories:

1. **Pooled fund trust** – paragraphs 204.4(2)(a) and (b);
2. **Mutual fund trust** – paragraphs 204.4(2)(c) and (d); and
3. **Mutual fund corporations and investment corporation** – paragraphs 204.4(2)(e) and (f).

Beyond these three main categories, the CRA may also accept certain trusts with similar characteristics to pooled fund trusts and mutual fund trusts in specific circumstances ("Quasi-Pooled Trusts" or "Quasi-MFTs") along with certain corporations that are not mutual fund corporations or investment corporations.

Qualifying as a pooled fund trust

In order for a pooled fund trust to qualify as an RI under paragraph 204.4(2)(a) of the Act the trust must have only one trustee that is a corporation licensed or otherwise authorized under the laws of Canada or a province to carry on in Canada the business of offering to the public its services as trustee where the following conditions apply:

1. **Beneficiary test** – All the property of the trust is held in trust for the benefit of not fewer than 20 beneficiaries. Further, one of the two following conditions must be met: (i) at least 20 beneficiaries must be pension funds, master trusts, or DPSP trusts, or (ii) at least 100 beneficiaries in the trust are RRSPs or RRIFs.

2. **Investment value test** – The fair market value ("FMV") of the trust’s property that is
   - Shares, marketable securities, cash
   - Bonds, debentures, mortgages, hypothecary claims, notes and other similar obligations; and
   - Real property held to produce income
   must be at least 80% of the total FMV of trust property (net of amounts owing on the acquisition of any real property).

3. **Diversification tests** – Under the first diversification test, no more than 10% of the FMV of the trust’s property (net of amounts owing on the acquisition of real property) at the time of acquisition may consist of shares, bonds, mortgages, hypothecary claims, and other securities of any one corporation or debtor. Securities in respect of the Canadian federal, provincial, or a municipal government are exceptions to this requirement.

   Under the second diversification test, the FMV of a real property held by the trust, as determined at the time of acquisition (net of amounts owing on the acquisition thereof), must not be greater than 10% of the FMV of all the trust’s property.

4. **Income test** – At least 95% of the income of the trust for its most recently completed fiscal period must have been derived from: (i) shares, marketable securities, and cash, (ii) bonds, debentures, mortgages, hypothecary claims, notes and other similar obligations, or (iii) real property.

5. **Ownership test** – The total value of all interests in the trust held by pension funds, master trusts, or DPSP trusts that are single employer contributor funds (or single employer together with non-arm’s length parties) cannot exceed more than 25% of the FMV of the trust’s property.

   Similarly, the total value of all interests in the trust held by RRSPs or RRIFs, to which a single taxpayer (or a single taxpayer together with non-arm’s length parties) is a contributor, cannot exceed more than 25% of the FMV of the trust’s property.
6. **Property test** – The trust must not hold any of the following types of property:
   - Mortgage or hypothecary claims in respect of which the debtor is the annuitant under a RRIF or RRSP (certain exceptions apply)
   - Bond, debenture, note, or similar obligation issued by a co-operative corporation or credit union that has granted any benefit to any annuitant under an RRSP, RRIF, or DPSP that is related to or dependent on:
     - Ownership by a trust governed by any such plan or fund of shares, bonds, debentures, notes, or similar obligations of the co-operative corporation or credit union
     - Ownership by the applicant of shares, bonds, debentures, notes, or similar obligations of the co-operative corporation or credit union if the plan trust governed any such plan or used any of its funds to acquire an interest in the applicant

Where a trust does not meet all tests but the beneficiary test and the ownership test above, it may still qualify as an RI under the Quasi-Pooled Trust category. This category requires the trust to restrict its investments to prescribed investments for the type of plan in respect of which it is registered.

**Qualifying as a mutual fund trust**
Provided the trust meets the definition of “mutual fund trust” (“MFT”) it will qualify as an RI in the year. Please refer to the section on MFTs for more information.

Where a trust does not meet the definition of an MFT by virtue of failing the dispersal of ownership requirement, the trust may still qualify as an RI under the Quasi-MFT category. This category requires the trust to restrict its investments to prescribed investments for the type of plan in respect of which it is registered.

**Qualifying as a mutual fund corporation or investment corporation**
Provided the corporation meets the definition of a mutual fund corporation (“MFC”) or investment corporation (“IC”) it will qualify as an RI in the year. Please refer to applicable sections of this publication for more information on MFCs and ICs, respectively.

Where a corporation does not meet the definition of MFC or IC as a result of not meeting ownership dispersal thresholds required to elect to be a public corporation, the entity may still qualify as an RI under the Quasi-MFC or Quasi-IC category. This category requires the corporation to restrict its investments to prescribed investments for the type of plan in respect of which it is registered.

**Penalty taxes**

**Qualifying under multiple categories**
Certain entities may qualify as an RI under more than one category in paragraphs 204.4(2) (a) to (f) of the Act. For instance, it may be that an MFT will also qualify under the pooled fund trust condition in a given taxation year. Where this is the case, a deeming rule will apply to determine which category the trust or corporation has qualified under in the tax year. This deeming rule establishes an order or hierarchy to which of the conditions in paragraphs 204.4(2) (a) to (f) applies. In general, the order outlined in the rule is meant to minimize the amount of tax to which a registered investment would otherwise be liable.

The ordering of the RI qualification categories is as follows:
1. MFT, MFC or IC;
2. Pooled fund trust;
3. Quasi-MFT, Quasi-MFC, or Quasi-IC;
4. Quasi-pooled fund trust.

For example, if the trust in question met the definition of pooled fund trust in a given taxation year, but also met the definition of MFT, the ordering rule would deem the trust to be considered an RI that is an MFT in the year, and not a pooled fund trust.
Penalty taxes – qualified investments

There are three types of penalty taxes that may apply to trusts governed by a deferred income plan that have invested in non-qualified investments. Note that these penalties are based on the FMV of the non-qualified investment as at the date of acquisition.

<table>
<thead>
<tr>
<th>Penalty</th>
<th>Type(s) of deferred income plan affected</th>
<th>Amount of penalty</th>
<th>Refundable?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Part X97</td>
<td>DPSPs</td>
<td>100% of the FMV of the non-qualified investment</td>
<td>Yes, subject to certain restrictions</td>
</tr>
<tr>
<td>Part XI.0158</td>
<td>RRSPs, RRIFs</td>
<td>50% of the FMV of the non-qualified investment</td>
<td>Yes, subject to certain restrictions</td>
</tr>
<tr>
<td>Part XI.159</td>
<td>DPSPs</td>
<td>1% of the FMV of any non-qualified investment held by the DPSP trust. This tax is to be paid on a monthly basis for as long as the DPSP holds the non-qualified investment</td>
<td>No</td>
</tr>
</tbody>
</table>

Furthermore, investors in RRSPs or RRIFs may be taxable at their respective marginal tax rates on any income or gain earned by the plan while it holds the non-qualified investment.60

Penalty taxes – registered investments

Additionally, Part X.2 prescribes penalty taxes in respect of non-qualifying RIs. In essence, these penalties are intended to ensure that trusts governed by a deferred income plan are not able to circumvent the Part X, XI.01, or XI.1 penalty taxes by holding non-qualified investments through an entity which is itself a qualified investment. There are three types of penalty taxes that may apply to the RI:

<table>
<thead>
<tr>
<th>Penalty</th>
<th>Amount of penalty</th>
</tr>
</thead>
<tbody>
<tr>
<td>Part X.2 – Breach of prescribed investment requirements for Quasi-entities61</td>
<td>1% of the FMV of the investment that is not a prescribed investment. The FMV of the investment is based on the FMV at date of acquisition. This tax is to be paid on a monthly basis for as long as the RI remains in breach.</td>
</tr>
</tbody>
</table>
| Part X.2 – Breach of diversification test with respect to shares, bonds, mortgages, hypothecary claims, or certain other debts62 | 1% of the excess of:
1. Total FMV of all prescribed property held by the trust, over
2. 10% of the FMV of all trust property (net of real property acquisition costs). This tax is to be paid on a monthly basis for as long as the RI remains in breach. |
| Part X.2 – Breach of diversification test with respect to real property63 | 1% of the excess of:
1. FMV of the real property at the end of the month (net of acquisition costs), over
2. 10% of the FMV of all trust property (measured at acquisition date) net of any real property acquisition costs. This tax is to be paid on a monthly basis for as long as the RI remains in breach. |

Revocation or suspension of registration

The CRA has the authority to revoke the registration of any RI where it breaches the conditions of its registration (other than a breach that would make the entity liable to penalty taxes). A notice of revocation can be cancelled where, within three months of receipt of the notice, the CRA receives satisfactory evidence that the entity meets the requirements to be an RI.

Where a revocation notice has been received by a taxpayer, it will be deemed to be considered an RI until the end of the year after the year in which the revocation notice was received. This is to ensure that revoked RIs still remain subject to penalty taxes in respect of any non-prescribed property they hold.

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Compliance requirements

A trust or corporation should file a Form T2217 – Application for Registration as a Registered Investment with the CRA to apply for treatment as an RI.

Within 90 days of the end of the trust’s taxation year, a registered investment trust must compute and pay any tax payable under Part X.2 in respect of each month of the year and file a Form T3RI – Registered Investment Income Tax Return. This return must be filed even where no tax is payable.

98 Qualified investments are also relevant to RESPs. However, this section is concerned with application of RIs to RRIFs, RRSPs, and DPSPs and thus RESPs were not specifically mentioned above.
99 Definition of “Qualified Investment,” Income Tax Act (Canada) Section 204
101 Income Tax Act (Canada) Paragraph 204.4(2)(a)
102 Income Tax Act (Canada) Paragraph 204.4(2)(b)
103 Ibid, Paragraph 204.4(2)(d)
104 Ibid, Paragraph 204.4(2)(f)
105 Income Tax Act (Canada), 204.4(7)
106 Ibid, Subsections 198(1) and (2)
107 Ibid, Subsections 207.04(2) and (4)
108 Ibid, Subsection 207.1(2)
109 Ibid, Subsections 146(10) and 146.3(9)
110 Income Tax Act (Canada) Subsection 204.6(1)
111 Ibid, Subsection 204.8(2)
112 Ibid, Subsection 204.8(3)
Canadian income tax characterization of income/gains and expenses/losses
Income type and tax treatment

Unit trusts ("UTs"), mutual fund trusts ("MFTs") and mutual fund corporations ("MFCs") operate as flow-through entities. For tax purposes, a flow-through entity treats the taxable income it earns as if the investor held the investments directly. The income distributed to investors retains its character, except in the case of interest income and foreign income earned by an MFT. Dividend income and capital gains will remain as dividend income and capital gains respectively when they are flowed out to investors.

Application to asset management industry

The types of income received by an MFC, MFT and a UT are outlined below, along with the tax treatment of the distribution to an individual, corporate and non-resident unit holder.
**Mutual Fund Corporation (MFC):**

<table>
<thead>
<tr>
<th>Type of income</th>
<th>Tax treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable Canadian dividends</td>
<td>- Generally deductible under s.112, therefore not taxable under Part I&lt;br&gt;- Might be subject to Part IV tax, which is refundable when taxable dividend distributions are made&lt;br&gt;- Retain their form as taxable Canadian dividends on distribution to security holders</td>
</tr>
<tr>
<td>Return of capital (ROC)</td>
<td>- ROC received is not generally taxable to the MFC&lt;br&gt;- Allocation of ROC is not generally deductible to the MFC</td>
</tr>
<tr>
<td>Taxable capital gains</td>
<td>- Only 50% of a capital gain is taxable&lt;br&gt;- Distribution of net capital gain (after application of capital loss carry forward, capital gain refund mechanism (&quot;CGRM&quot;) and allocation to redeemers*) is permissible.&lt;br&gt;  <em>See CGRM and Allocation to redeemers sections for further details</em></td>
</tr>
<tr>
<td>Other income (Interest, trust income, etc.)</td>
<td>- Fully taxable to the MFC; can be offset with operating expenses in the year and non-capital loss carry forwards</td>
</tr>
<tr>
<td>Foreign-source income and taxes</td>
<td>- Fully taxable to the MFC; can be offset with operating expenses in the year and non-capital loss carry forwards</td>
</tr>
</tbody>
</table>

**Mutual Fund Trust (MFT):**

<table>
<thead>
<tr>
<th>Type of income</th>
<th>Tax treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable Canadian dividends</td>
<td>- Subject to gross-up and eligible for dividend tax credit&lt;br&gt;- Retain their form as taxable Canadian dividends on distribution to unit holders</td>
</tr>
<tr>
<td>Return of capital (ROC)</td>
<td>- ROC received is not generally taxable to the MFT&lt;br&gt;- Allocation of ROC is not generally deductible to the MFT</td>
</tr>
<tr>
<td>Taxable capital gains</td>
<td>- Only 50% of a capital gain is taxable&lt;br&gt;- Distribution of net capital gain (after application of capital loss carry forward, CGRM and allocation to redeemers*) is permissible.&lt;br&gt;  <em>See CGRM and Allocation to redeemers sections for further details</em></td>
</tr>
<tr>
<td>Other income (Interest, trust income, etc.)</td>
<td>- Fully taxable to the MFT; can be offset with operating expenses in the year and non-capital loss carry forwards&lt;br&gt;- Income distributed to investors can be deducted in computing the taxable income of the MFT.</td>
</tr>
<tr>
<td>Foreign-source income and taxes</td>
<td>- Fully taxable to the MFT; can be offset with operating expenses in the year and non-capital loss carry forwards&lt;br&gt;- Income distributed to investors can be deducted in computing the taxable income of the MFT.&lt;br&gt;- The MFT can deduct any foreign tax paid at the fund level or distribute it to investors.&lt;br&gt;  <em>(See Foreign withholding tax section for more details)</em></td>
</tr>
</tbody>
</table>
### UnitTrust (UT):

<table>
<thead>
<tr>
<th>Type of income</th>
<th>Tax treatment</th>
</tr>
</thead>
</table>
| Taxable Canadian dividends | Subject to gross-up and eligible for dividend tax credit  
Retain their form as taxable Canadian dividends on distribution to unit holders  
Claiming dividend tax credit could trigger alternative minimum tax in a unit trust |
| Return of capital (ROC) | ROC received is not generally taxable to the UT  
Allocation of ROC is not generally deductible to the UT |
| Taxable capital gains   | Only 50% of a capital gain is taxable  
Distribution of net capital gain (after application of capital loss carry forward and allocation to redeemers*) is permissible. CGRM is not available for UTs.  
*See Allocation to redeemers section for further details |
| Other income (interest, trust income, etc.) | Fully taxable to the UT; can be offset with operating expenses in the year and non-capital loss carry forwards.  
Income distributed to investors can be deducted in computing the taxable income of the UT. |
| Foreign-source income and taxes | Fully taxable to the UT; can be offset with operating expenses in the year and non-capital loss carry forwards.  
Income distributed to investors can be deducted in computing the taxable income of the UT.  
The UT can deduct any foreign tax paid at the fund level or distribute it to investors.  
(See Foreign withholding tax section for more details) |

### Individual unitholder:

<table>
<thead>
<tr>
<th>Type of income</th>
<th>Tax treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable Canadian dividends</td>
<td>Subject to gross-up and eligible for dividend tax credit</td>
</tr>
</tbody>
</table>
| Return of capital (ROC) | Not generally taxable to Canadian unit holders  
Reduces adjusted cost base (“ACB”) of the units, which increases capital gain realized upon disposition |
| Taxable capital gains   | Only 50% of a capital gain distribution is taxable  
Distribution of capital gains from UT/MFT/MFC will retain its character as capital gain. |
| Other income (interest, trust income, etc.) | Income distributed and deducted by the UT and MFT is fully taxable to unit holders  
Where income distributed and fully taxable to investors is not actually paid, the ACB of the units will increase by the amount of the distribution |
| Foreign-source income and taxes | Income is fully taxable to the investor  
If foreign tax paid is distributed to investors, each investor can claim a foreign tax credit to the extent that there is sufficient foreign income against which to claim the foreign tax credit |
Corporate unitholder:

<table>
<thead>
<tr>
<th>Type of income</th>
<th>Tax treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable Canadian dividends</td>
<td>- May be eligible for deduction under Section 112 of the Act</td>
</tr>
<tr>
<td>Return of capital (ROC)</td>
<td>- Not generally taxable to Canadian unit holders</td>
</tr>
<tr>
<td></td>
<td>- Reduces ACB of the units, which increases capital gain realized upon disposition</td>
</tr>
<tr>
<td>Taxable capital gains</td>
<td>- Only 50% of a capital gain distribution is taxable</td>
</tr>
<tr>
<td></td>
<td>- Distribution of capital gain from UT/MFT/MFC will retain its character as capital gain</td>
</tr>
<tr>
<td>Other income (interest, trust income, etc.)</td>
<td>- Income distributed and deducted by the UT and MFT is fully taxable to unit holders</td>
</tr>
<tr>
<td></td>
<td>- Where income distributed and fully taxable to the investors is not actually paid, the ACB of the units will increase by the amount of the distribution</td>
</tr>
<tr>
<td>Foreign-source income and taxes</td>
<td>- Income is fully taxable to the investor</td>
</tr>
<tr>
<td></td>
<td>- If foreign tax paid is distributed to investors, the investor can claim a foreign tax credit to the extent that there is sufficient foreign income against which to claim the foreign tax credit</td>
</tr>
</tbody>
</table>

Section 39(4) election and implications

- An election under section 39(4) allows for the permanent treatment of Canadian securities held in the fund to be treated on account of capital to the extent certain criteria are met. As a result of the election, gains or losses on the disposition of those Canadian securities would be capital gains or capital losses, rather than on account of income. Capital gains would be 50% taxable. Gains or losses on account of income, however, are fully taxable and deductible when computing taxable income. The election can also apply to short sales.
- Funds make the election by filing Form T123 with the fund’s tax return. Once made, it cannot be revoked.
- A character-conversion transaction (i.e., derivative forward agreement) would still require an income inclusion that overrides the section 39(4) election.
- The section 39(4) election is beneficial for funds where there might be concerns about whether the gains and losses on the disposition of Canadian securities should be treated as business income instead of capital (i.e., day trading).

Key considerations for investment funds

- As remaining taxable income in an MFT and UT are taxed at the highest individual tax bracket, it is beneficial for an MFT and UT to distribute the required taxable income to unit holders to reduce taxable income to nil.
- Fund managers or administrators should consider optimizing use of the dividend tax credit to minimize the required dividend distributions from an MFT to investors. As a UT is subject to Alternative Minimum Tax (“AMT”), use of the dividend tax credit might trigger AMT. Generally, all dividends earned in a UT are distributed to investors.
- Fund managers or administrators should identify the portion of capital gains that can be considered Allocation to Redeemers. This amount is deductible to the fund. Any remaining capital gains net of the deduction could then be further distributed to unit holders.
- Fund managers should consider whether to file a section 39(4) election to treat gains or losses on disposition of Canadian securities as capital gains or losses.
- Fund managers or administrators should review any corporate actions that might result in additional income to the fund, whether capital gain or dividend income. The characterization of the income should be identified.
Capital gains refund mechanism

The capital gains refund mechanism ("CGRM") is a concept specific to mutual fund trusts ("MFTs") and mutual fund corporations ("MFCs"). Its purpose is to relieve potential double-taxation on capital gains realized from investor redemptions.

Two cases of taxation may arise from redemption of investment units:

1. Tax paid by the investor for the capital gains realized upon disposition of his or her units.
2. Tax paid by the remaining investors of the MFT or MFC for capital gains realized within the fund as a result of selling underlying assets to pay for the redemption.

The following example illustrates the concept of double taxation.

Simplified example:

An MFT (the "Fund") has three investors: Investor A, B, and C. Investor A decides to redeem all of her units (assuming she owns 10% of the units) in the Fund for $20,000. Her initial investment in the Fund was $10,000, resulting in a capital gain of $10,000.

In order to fund Investor A's redemption, the Fund sells 10% of its underlying assets and realizes a capital gain of $10,000. This capital gain is distributed to the remaining investors (Investors B and C) as Investor A has already redeemed all of her units and is no longer a member of the MFT.

Investor A must include the $10,000 capital gain in income that she realized as a result of selling her units. At the same time, Investors B and C will also include their share of the $10,000 capital gain distributed by the trust. Effectively, tax will be paid twice on the same $10,000 capital gain; once by Investor A and a second time by Investors B and C.

What does the CGRM do?

The CGRM aims to address the double taxation issue by providing a refund to the MFT or MFC. Essentially, because of the CGRM, the Fund as described in the previous example does not need to distribute the $10,000 capital gain to Investors B and C. The CGRM works in a similar manner for an MFC.

The CGRM is a tool that addresses capital gains realized within MFTs or MFCs upon liquidating investor redemptions. It allows MFTs and MFCs to retain a portion of the capital gains realized without incurring any tax liabilities for the fund.
Formula and definitions

**Capital gain refund:**
For an MFT\(^64\), capital gain refund is calculated as the lesser of:
1. The total of
   a. 16.5% of the total of the trust’s capital gains redemptions for the year, and
   b. An amount that the Minister may determine is reasonable in the circumstances
2. The trust’s refundable capital gains tax on hand at the end of the year

For an MFC\(^65\), capital gain refund is calculated as the lesser of:
1. The total of
   a. 14% of the total of the corporation’s capital gains redemptions, and all capital gains dividends paid by the corporation in the period commencing 60 days after the beginning of the year and ending 60 days after the end of the year, and
   b. An amount that the Minister of Finance may determine is reasonable in the circumstances,
2. The corporation’s refundable capital gains tax on hand at the end of the year.

Although the definitions of capital gain refund for both MFTs and MFCs are determined in reference to “capital gains redemptions,” the formula for determining capital gains redemptions in the case of an MFT differs slightly from that of an MFC.

**Capital gains redemptions**

For an MFT\(^66\)

\[
A \times \frac{C + D}{B} - E
\]

For an MFC\(^67\)

\[
A \times \frac{C + D}{B}
\]

In very general terms, the component variables of the two formulas are defined as:

- **A** Amount paid in the year to redeem units/shares
- **B** Total of redemptions paid + FMV of units/shares that remain outstanding at year-end
- **C** \(100/14.5\) x the MFT’s (or \(100/14\) x the MFC’s) refundable capital gains tax on hand at year-end
- **D** The proxy of the unrealized gains remaining in the MFT/MFC
- **E** \(2\) x the amount of taxable capital gains designated to beneficiaries for units redeemed

Conceptually, the capital gain refund formula determines the amount of realized capital gains that can be retained by an MFT or MFC without being subject to tax at the fund level. However, the formula is a proxy and does not always result in a perfect match. To the extent that retainable capital gains exceed realized gains during any given year, the excess is lost and cannot be carried forward for future years.

**Refundable capital gains tax on hand (RCGTOH)**

Alternatively, when an MFT or MFC pays tax on realized capital gains that are in excess of refunded capital gains during the year, this tax will be added to the RCGTOH account balance for the subsequent year. The balance in the RCGTOH account is carried forward to future years when there has been sufficient capital gains redemptions and capital gains dividends paid (in the case of an MFC) to investors.

**Attribution to redeemers**

Many MFTs can attribute taxable capital gains to redeemers. As illustrated by the formula, twice the amount of taxable capital gains that are attributed to redeemers reduces the capital gains refund. In many cases, the entire capital gains refund can be reduced to nil by capital gains attributed to redeemers.

Whether or not an MFT attributes capital gains to redeemers does not alter the tax position of the redeemers. Any capital gains attributed to redeemers will reduce the redemption proceeds. In other words, redeemers realize the same amount of capital gains with or without attributions from the MFT.
Summary
The CGRM alleviates potential double taxation that would otherwise occur for investors who remain in the MFT/MFC as the entity realizes capital gains that result from redemptions. The computation of refundable capital gains is fraught with precision and complexity, which highlights the need for reliable input of information. It is advisable for an MFT/MFC to have a reliable accounting system that can produce relevant data for purposes of the CGRM. Key areas to consider include, but are not limited to, the cost base of properties, tax treatment of corporate actions, suspended losses, characterization of income, and currency translations.

Recent developments
Ontario surtax:
Effective 2014 and onward, Ontario tax is calculated based on Ontario tax before claiming a deduction for dividend tax credits. The CGRM was initially not updated to reflect the change in surtax computation. This resulted in a mismatch, where the amount of capital gains refund would not properly offset the surtax payable on capital gains retained. The CGRM was consequently amended in Ontario’s 2015 budget to address the change in surtax calculation. The CRA has taken the position that assessed returns will not be automatically reprocessed for this legislative relief. A notice of objection or T3 Adjustment Request must be filed with the CRA to reflect the change.

2016 amendments:
On December 7, 2015, the top personal income tax rate for individuals increased from 29% to 33% for individuals (including trusts) for the 2016 taxation period. To address the rate increase, the 2016 Federal Budget amended the capital gain refund formula. Under the amendment, clause 132(1)(a)(i)(A) and (B) has been revised to:

(A) 16.5% of the total of the MFT’s capital gains redemptions for the year and
(B) the amount that the Minister determines to be reasonable in the circumstances, after giving consideration to the percentages applicable in determining the MFT’s capital gains refunds for the year or any previous taxation year and the percentages applicable in determining the MFT’s refundable capital gains tax on hand at the end of the year.

Similarly, the capital gains redemption formula has revised the reciprocal used in “C” to 100/16.5 from 100/14.5, to be consistent with the updated 33% marginal rate.

In addition, the 2016 Federal Budget amended the Income Tax Act, Canada (“the Act”) so that an investor who switches classes in an MFC through an exchange of shares will be considered to have made a disposition at fair market value. Note that a disposition is not recognized if the shares exchanged only differ in regards to management fees or expenses and derive value from the same underlying portfolio or fund. Discussions are underway with the Department of Finance to address the definition of the term “redemption” in the case of a taxable switch between classes of an MFC, as this would have further impact on the capital gains refund formula.

Application to asset management industry
Many investment funds in the asset management industry may qualify for MFT status. As such, there is opportunity for these funds to benefit from the CGRM.

In general, the CGRM will be effective for sheltering capital gains within investment funds that have substantial redemptions during the year, and that hold a considerable amount of unrealized gains. In addition, investment funds that feature low portfolio turnover (i.e., minimal trading of securities) are in a better position to benefit from the CGRM. In contrast, investment funds with low redemptions and/or significant net unrealized losses may not benefit as much from the CGRM.

64 Income Tax Act (Canada) Subsection 132(1)
65 Ibid, Subsection 131(2)
66 Ibid, Subsection 132(4)
67 Ibid, Subsection 131(6)
68 Income Tax Act (Canada) Section 105
69 Bill C-15, Received first hearing April 20, 2016.
Derivative instruments

A derivative is a contract or agreement between two or more parties that derives its value from fluctuations in the price of an underlying asset (e.g., corporate share or bond) or reference rate (e.g., interest rate stock index). A derivative instrument may be entered into either through standardized exchange contracts or on a customized over-the-counter basis (“OTC”).

Derivative instruments may be net settled in cash for the fair market value of the contract at maturity, sold on an exchange, or by an exchange of the underlying asset itself.

Some common derivative instruments include:

- Forward purchase and sale agreement
- Interest rate swaps
- Futures contracts
- Total return swaps
- Put options
- Call options

Generally, a derivative instrument is used to either:

- Earn income from speculation on future movements in the value of the underlying asset or reference rate, or
- To hedge against the risk of a particular exposure (e.g., market risk, interest rate risk, credit risk).

The Income Tax Act, Canada (“the Act”) does not provide any specific guidance on the taxation of derivative instruments, other than certain anti-avoidance character conversion provisions. In general, the CRA’s stated position on the tax treatment of gains or losses from derivative instruments will depend on the specific facts of the particular transaction. CRA’s default position is that a derivative instrument will be taxed on account of income unless it is sufficiently linked to an underlying capital asset; however, these statements are not meant to be interpreted as overriding the principal tests for capital treatment established by law.
Where a derivative instrument is being used for hedging purposes and is sufficiently linked to an underlying capital property, the tax characterization of gains and losses will be treated in a similar manner as the gains and losses from the underlying property. To the extent that a derivative instrument is not utilized for hedging certain risks associated with certain capital properties, any gains or losses will generally be on income account as realized or mark-to-market depending on specific facts and circumstances.

For a taxpayer to determine whether sufficient linkage exists in the case of a derivative instrument being utilized for hedging purposes, the CRA has outlined certain criteria that may be considered:

- There must be a transaction, or a proposed transaction
- The transaction must be in the same legal entity as the hedge
- The timing and maturity dates should reflect the underlying transaction, but perfect matching is not required
- The accounting treatment of the derivative does not necessarily determine its tax treatment

These criteria do not consider recent jurisprudence, and the CRA has not made any recent comments about the general characterization of derivative instruments other than that each situation will be considered on its own particular facts.

**Linkage for tax purposes**

In *George Weston Limited v. The Queen* ([2015] 4 CTC 2010 (TCC)), the Tax Court of Canada (“TCC”) provided guidance with respect to the characterization of derivative instruments. In this case, the TCC found that a derivative entered into by a taxpayer for the purpose of mitigating foreign currency exposure in relation to indirect subsidiaries is a hedge for tax purposes, and taxable on account of capital. Although there was no discrete capital transaction and the hedge was entered into by a different legal entity than the entity to which the exposure being hedged related, the TCC perceived a sufficient link between the swap agreements and an underlying capital item creating the hedged risk, such that the swaps could be characterized as being on account of capital.

The CRA said it accepted the TCC decision in *George Weston* and will apply it in appropriate circumstances. The Agency commented that the ability to treat a hedging gain on capital account will always depend on the facts of a case. Furthermore, the CRA said there still must be some factual support for the linkage between the hedge and underlying asset being hedged.

However, in a technical interpretation addressing the application of *George Weston*, the CRA said that its long-standing position that interest rate swaps are characterized on account of income remains unchanged. In particular, the CRA draws a distinction from the *George Weston* ruling saying that case is specific to foreign exchange rate swaps and not interest rate swaps.

**Income recognition**

In *Kruger Incorporated v. The Queen* (2016 FCA 186), the Federal Court of Appeal (FCA) determined that Kruger Incorporated, a non-financial institution (as defined by the Act), could apply the mark-to-market accounting method to its foreign exchange (FX) options for tax purposes on the basis that Kruger “carried on a business of speculating on foreign exchange currency options” even though it was not a financial institution as defined under the Act. The FCA overturned the TCC’s previous decision determining that the mark-to-market accounting principle provided an accurate picture of Kruger’s income and the realization principle did not provide a better picture in this particular case. This case provides guidance for investment funds on the timing of gains and losses on open derivative contracts that straddle the tax year-end of the fund. Investment managers should undertake similar analysis to determine which income recognition method is most appropriate based on a fund’s particular investment strategy.

**Mark-to-market election**

In addition to the Kruger FCA decision, the 2017 budget proposes to amend section 10 of the Act to include mark-to-market election rules with respect to derivatives. The new rules reinforce the idea that a taxpayer should have the ability to choose an income recognition method that best reflects their economic reality.

An election will be available for taxation years that begin on or after March 22, 2017 that will allow eligible derivatives to be treated as mark-to-market property. An eligible derivative is defined under subsection 10.1(4) as a swap agreement, a forward purchase or sale agreement, a forward rate agreement, a futures agreement, an option agreement or a similar agreement if:

- The agreement is not on the account of capital
- Audited financial statements have been prepared in accordance with GAAP or
- the agreement has an ascertainable fair market value
c. Where the agreement is held by a financial institution (defined under subsection 142.2(1)), the agreement is not a tracking property, other than an excluded property, of the financial institution.

Through making this election, any changes in fair value of eligible derivatives during the election year and subsequent years shall be included in taxable income on an annual basis. Accrued gains and losses preceding the election year will be deferred until the actual disposition of the asset as a form of transitional relief. It is important to note that once the election is made, it will be irrevocable apart from the consent of the Minister. Given the enduring nature of this election, investment funds should carefully consider whether or not it is appropriate to make such an election. By default, derivatives will be treated on the usual realization basis under subsection 10.1(7).

Character conversion transactions (CCT)

In 2013, the Federal Budget announced proposals to eliminate the use of derivative contracts for converting taxable amounts of income from property into capital gains. CCT legislation is designed to eliminate the use of derivative forward agreements (DFA) and enable taxation of the resulting economic gains as ordinary income. In general, a DFA is an agreement with a term exceeding 180 days combining a derivative instrument and the sale or purchase of an unrelated capital asset. The Act also determines what constitutes the aggregate term of a series of agreements, thus prohibiting the use of legally separate but economically-related agreements of shorter duration in order to circumvent the 180-day test.

Subparagraph (c)(ii) of the definition provides that an agreement will not be a DFA where the taxpayer retains a majority of the economic exposure to loss and opportunity for gain or profit on the property being sold for a period of more than 180 days (a deeming rule applies where such agreements are entered into by non-arm’s length persons). This ensures that the CCT rules will not apply where the taxpayer’s economic exposure is still based primarily on the property being sold, even if there is a derivative component to the sale agreement.

The CCT came into force on March 21, 2013 and applies to acquisitions and dispositions of property under a DFA entered into after March 20, 2013. DFAs entered into after March 20, 2013 but before July 11, 2013 could have been grandfathered for a period not exceeding 180 days. Where a predecessor agreement was entered into before March 21, 2013 but did not have a settlement period prior to December 31, 2014, such transitional relief was extended to the later of the final settlement period after December 31, 2014 or March 21, 2018. These transitional measures are provided as long as the taxpayer complies with certain conditions relating to the size of the DFA.

Compliance requirements

Although there are no prescribed forms or filings that reduce the risk of reassessment and penalties for a tax position taken in respect of a derivative instrument, it would be prudent for the taxpayer to document the particular reasons for the use of the derivative instrument, and whether and how it is linked to an underlying capital property when hedging treatment is applied. Lastly, notwithstanding any deeming provision in the Act, a taxpayer should also document justification of the timing of income or loss recognition, and how this recognition provides an accurate and consistent depiction of taxable income for the period.
Synthetic disposition arrangement

The synthetic disposition arrangement (“SDA”) rules apply to SDAs entered into after March 20, 2013, and impact taxpayers including investment funds. An SDA is defined as one or more agreements or other arrangements that have the effect of eliminating all or substantially all of both the taxpayer’s risk of loss and opportunity for gain or profit in respect to an underlying property for a definite or indefinite period of time. The SDA rules apply when the period of the arrangement is more than one year.

The SDA rules do not apply:

- Where the disposition of the property does not result in the realization of a capital gain or income at the time of entering into the SDA
- Where the property is a mark-to-market property
- To leases of tangible property or for civil law, corporeal property
- To arrangements that are an exchange of property to which the tax deferral rules for convertible properties apply; or
- Where the property is disposed of as part of the arrangement, within one year of the commencement of the SDA

Where the SDA rules apply, a taxpayer is deemed to have disposed of the property at its fair market value and to have immediately reacquired the property at that fair market value. The deemed disposition occurs at the beginning of the synthetic disposition period. Accordingly, the taxpayer realizes any accrued gains immediately.

To ensure that a taxpayer cannot obtain tax benefits associated with continued ownership of a property after entering into an SDA, the SDA rules interact with various stop-loss rules. For example, with respect to the dividend stop-loss rules, the taxpayer will be considered not to own the property for purposes of determining whether the taxpayer meets the holding-period test. The dividend stop-loss rules generally reduce a taxpayer’s realized losses on a disposition of shares by the amount of deductible dividends received on those shares. There are exceptions to
the dividend stop-loss rules, one of which requires the taxpayer to hold the shares throughout the 365-day period before the SDA was first entered into. If the SDA rules apply, for purposes of the 365-day ownership requirement threshold, the taxpayer will be deemed not to own the shares during the synthetic disposition period if that period is 30 days or more.

In addition, the holding period test is affected for purposes of applying foreign tax credit. Foreign tax credits are limited in respect of dividends or interest on a share or debt obligation held by a taxpayer for one year or less.\(^81\) Where the SDA rules apply and the synthetic disposition period is 30 days or more, the one-year holding period test for the purposes of foreign tax credits will not be met unless the taxpayer continues to own the property for at least one year after the end of the synthetic disposition period.\(^82\)

**Application to asset management industry**

The SDA rules do not contain a purpose test. Therefore, even transactions not motivated by deferring the recognition of a gain, may be caught. To help articulate the scope of the rules, the Department of Finance (“Finance”), in its Explanatory Notes, provided examples of transactions that may be subject to the SDA rules:

- Forward sale of property (whether or not combined with a secured loan)
- Put-call collar on an underlying property
- Issuance of certain indebtedness that is exchangeable for property
- Total return swap on property
- Securities borrowing to facilitate a short sale of property that is identical or economically similar to a property belonging to the taxpayer (or a non-arm’s length person)

Finance also noted that the SDA rules do not generally apply to ordinary hedging transactions, which typically only involve managing the risk of loss. Also, the rules are not intended to affect the tax treatment of ordinary course securities lending arrangements, nor to apply to ordinary commercial leasing transactions.

**Compliance requirements**

There are no prescribed forms to be completed; however, investment managers should analyze the underlying fund strategy to determine whether certain financial instruments might be used to effectively eliminate market risk associated with certain investment holdings. This is advisable even when it may appear that a particular arrangement or agreement does not have a term greater than one year.

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\(^{81}\) Income Tax Act (Canada) Subsection 248(1)
\(^{82}\) Ibid, Subsection 80.6(1)
Securities lending arrangements

A securities lending arrangement ("SLA") is a transaction between parties that involves the loaning of securities by one market participant (lender) to a counterparty (borrower). To manage credit risk between the transacting parties, the counterparty is generally required to provide collateral, whether in cash, other securities, or a letter of credit.

Regulated intermediaries such as brokers and/or dealers conduct securities lending transactions. When a security is loaned, the title and ownership of that security is temporarily transferred to the borrower. Since ownership has been temporarily transferred to the borrower, the borrower is liable to pay any income from the borrowed security back to the lender. A lender is also compensated with fees agreed upon by the intermediary, which also levies a fee on the borrower. The intermediary generally makes a spread on securities lending transactions.

The following diagram illustrates cash flows between the borrower and lender on a loan of shares:

Although ownership and title of the securities in an SLA are temporarily transferred to the borrower from a securities law perspective, this does not necessarily mean that a disposition has occurred from a Canadian tax perspective.
**Tax definition**

An SLA is any arrangement where:

1. A lender transfers or lends a “qualified security” to another;
2. There is reasonable expectation at the time of transfer or loan that the borrower will transfer or return an identical security to the lender at a later time;
3. The borrower is obliged to pay the lender amounts that would have been received from the security if the lender did not transfer or lend the security;
4. The risk of loss or opportunity remains with the lender; and
5. The lender and borrower do not deal with each other at arm’s length, and the SLA arrangement does not last more than 270 days.

Note that in the definition of an SLA, the Income Tax Act, Canada (“the Act”) refers to an “arrangement,” so it is not necessary that the lender and the borrower enter into a legally enforceable contract for an SLA to occur. The definition also makes reference to a “transfer” or a “loan” of a qualified security, which is broad enough to encompass a repurchase transaction (commonly known as a “repo” transaction) or a stock loan whereby an actual sale of securities occurs with a contemporaneous agreement to repurchase the securities at a pre-determined price and date.

The term “qualified securities” is defined in the Act. It generally includes publicly traded shares or debt securities that are commonly sold short. There are five categories of securities under this definition:

1. A share of a corporation listed on a stock exchange or a share of a non-listed Canadian corporation where the issuer elects to be designated as a public corporation. A Canadian corporation is eligible to file an election to be designated as a public corporation if it meets certain prescribed conditions, such as a minimum number of shareholders and dispersal of ownership.
2. A bond, debenture, note or similar obligation of a corporation described in (1) above or of a corporation controlled by such a corporation;
3. A bond, debenture, note or similar obligation issued by a government or an entity controlled by a government (for instance, a Crown corporation);
4. A warrant, right, option or similar instrument with respect to a corporation described in (1) above; or
5. A “qualified trust unit” which is defined as a unit of a mutual fund trust (“MFT”) within subsection 132(6) that is listed on a stock exchange. This category is applicable to arrangements made after 2001.

For category (1) above a corporation listed on a stock exchange does not need to be a Canadian resident, and the shares can be listed on any stock exchange located anywhere in the world.

For the categories (2) and (3), control exists with the ownership of a sufficient number of voting shares to elect a majority of the board of directors.

As noted earlier, the borrower is required to pay the lender any amounts received from the borrowed securities. For example, if the borrowed security paid a quarterly dividend, the borrower would receive the dividend and would need to make an equal payment to the lender. Such payment is referred to as compensation payment. Essentially, the lender would be in the same position as if it were earning the dividend directly.

**Income tax consequences to the lender**

There is no disposition on transfer or loan of a qualified security.

An identical security that is returned to the lender is treated as the same security that was transferred or loaned originally.

Where an identical security is not returned to a lender, there would be a deemed disposition of the qualified security.

Where a property other than an identical security is returned to a lender because of a corporate reorganization, certain rollover provisions may be utilized to defer any taxable gains.

The character of compensation payments received by the lender is deemed to be one of the following:

1. A taxable dividend;
2. An amount paid by a trust having the same characteristics, source, and purpose as the underling amount paid by the trust; or
3. In all other cases, interest.
Income tax consequences to the borrower

There is a deemed acquisition of the borrowed securities, with the adjusted cost base (“ACB”) equal to the fair market value (“FMV”) of that property at the time of transfer.

Applicable to SLAs made after 2001, SLA and dealer compensation payments are deductible as follows:

- A registered security dealer\(^7\) is allowed to deduct no more than 2/3 of dividend compensation payments paid to a lender that are deemed to be taxable dividends received by the lender.

- Compensation payments other than taxable dividends are fully deductible where the borrower disposes of the borrowed securities in the year and includes the gain or loss, if any, from the disposition in income from a business. This also applies to a situation where the borrowed securities are mark-to-market property. In any other cases, compensation payments are deductible to the extent that distributions received on the borrowed securities are included in income.

- Expenses incurred by the borrower in the case where the securities held short are on account of capital would not be deductible by the taxpayer, nor be added to the ACB of the respective security. There may be exceptions to this limitation depending on the investment strategy of the fund.

- Expenses incurred by the borrower in the case where the securities held short are on income account should be deductible by the taxpayer.

- Where the SLA also constitutes a dividend rental arrangement (“DRA”), a deduction may be allowed.\(^8\)

Other considerations

Generally, where section 260 of the Act does not specify treatment of compensation payments, they may be deductible to a borrower as an outlay or expense incurred for the purpose of gaining or producing income from a business under subsection 9(1) of the Act, in the year that the short sale transaction is completed (i.e., in the year of purchase to replace the shares borrowed).

Where the short sale transaction is treated on account of capital by the borrower, there are limited arguments for allowing a deduction for a compensation payment in computing the income of a taxpayer, except where the transaction is governed under section 260 of the Act (see above). Compensatory payments that are not deductible as expenses may not be added to the ACB of the new securities acquired.

Note that SLAs are not limited to Canadian resident participants since cross-border transactions are very common in the investment fund industry. In such situations, consideration should be given to withholding tax requirements levied by the non-resident jurisdiction, or on remittance of withholding taxes required under Canadian tax law. From a Canadian withholding tax perspective, compensation payments, whether in the form of interest or dividend, are deemed by the Act to be interest payments for the purpose of Part XIII\(^9\) and are subject to withholding tax. However, there is an exception for SLAs that are “fully collateralized.”\(^9\) The applicable withholding tax rate could also be affected by the application of any respective tax treaties in place between the two countries.

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\(^{87}\) Income Tax Act (Canada) Subsection 260(1)

\(^{88}\) ITA 89(1)

\(^{89}\) Regulation 4800

\(^{90}\) Buckerfield's Ltd v. Minister of National Revenue, [1964] C.T.C. 504 (Exch).

\(^{91}\) Income Tax Act (Canada) Sections 51, 85, 86, 87

\(^{92}\) Means a person registered or licensed under the laws of a province to trade in securities, in the capacity of an agent or principal, without any restriction as to the types or kinds of securities in which that person may trade;

\(^{93}\) Income Tax Act (Canada) Subsection 260(6.1)

\(^{94}\) Income Tax Act (Canada) Paragraphs 260(8)(b) and (c)

\(^{95}\) Ibid, Subsection 260(8)
Stop loss rules

Stop loss rules are intended to prevent certain corporations or individuals from receiving tax-free dividends while simultaneously claiming a loss on the sale of the security.92 A capital loss incurred on the disposition of a corporate share by an individual or corporation may be reduced if certain dividends have been received on those shares.

Technical application

The application of the dividend stop-loss rules differs depending on the character of a share as capital or non-capital property of the taxpayer.

Capital property

Includes any non-depreciable property, the disposition of which would give rise to a capital gain/loss.

Capital property of a corporation or an individual other than a trust93

The Income Tax Act, Canada (“the Act”) applies the stop-loss rules where a share is owned, as capital property, by a corporation or an individual other than a trust.

- For corporations, the rules94 reduce the amount of capital loss realized on the disposition of a share by the deductible portion of:
  a. A taxable dividend
  b. A capital dividend
  c. A life insurance capital dividend
- For individuals other than a trust, the rules95 limit any reduction of a realized capital loss to the lesser of:
  a. Non-taxable capital dividends received by the individual on the share
  b. The realized loss less all taxable dividends received by the individual on the share

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Exception to the stop-loss rules exists in the Act. The stop-loss rules do not apply if:

- The taxpayer owned the share throughout the 365-day period before the disposition
- At the time the specified dividend was received, the taxpayer did not own more than 5% of the issued shares of any class of the capital stock of the dividend-paying corporation.
- For disposition of a share that is a redemption, acquisition or cancellation occurring after March 21, 2011, the dividend is not a deemed dividend received by a public corporation or a financial institution (also known as “Qualified Dividend”).

**Capital property of a partnership**

The stop-loss rules apply where a share is owned as capital property by a partnership and there are corporate partners. This ensures that a partnership is treated as a flow-through entity in the application of the stop-loss rules. Therefore, the stop-loss rule is applied at the level of each partner based on its share of any capital loss. The corporation’s share of a partnership capital loss is reduced by the total of all amounts received by the corporation on the particular share as capital dividends or taxable dividends that were deductible from the corporation’s taxable income.

**Capital property**

The stop-loss rules apply where a share is owned as capital property by a trust, other than a mutual fund trust, and a corporation is a beneficiary. The rules are similar to the rules in subsection 112(3) and (3.01); however, with respect to trusts, the loss is reduced by the total amounts of taxable dividend and/or life insurance capital dividend received on the share and designated as dividends deemed by the trust which are received by the beneficiary.

The Act permits the trust to designate for the year all or any part of the dividend to have formed a part of the amount that was included in computing the income for the year of each or any of its beneficiaries. The income retains its character as a dividend in the hands of the beneficiary. The effect of the designation is that the taxable dividend is considered to have been received in the year by the beneficiary, rather than by the trust itself.

If a trust designates the amount of the dividend in respect of the beneficiary, the relevant amount is not included in computing the income of the particular beneficiary. This occurs because the provision allows the trust to preserve the non-taxable character of a capital dividend on payment to a beneficiary.

**Non-capital property**

Three different dividend stop loss rules may apply to losses arising with respect to a share that is not held as capital property.

The basic rule reduces the amount of non-capital loss realized by a corporation, partnership or individual other than a trust by the amount of dividend received, unless the taxpayer and any non-arm’s length person owns a combined percentage of less than 5% of any class of shares and the shares were held for the previous 365-day period.

The fair market value of a share at any time is deemed to be equal to the fair market value of the share at the time, plus amounts of dividends received by the shareholder on the share before that time. By increasing the fair market value of the shares, the capital loss will be reduced.

The rules apply to loss on share held by a trust, whereby the loss is reduced by:

- Dividends received on the share to the extent that the amount was not designated under subsection 104(20) in respect of the beneficiary, and
- Dividends received on the share that was designated under 104(19) or (20) by the trust in respect of the beneficiary

The exclusions applicable to trusts in subsections 104(4.21) and (4.22) are the same as discussed above.
Synthetic disposition arrangements

The 2013 federal budget introduced a new anti-avoidance provisions to address “synthetic dispositions.” A synthetic disposition arrangement (“SDA”) a taxpayer would legally dispose of a property while still retaining an interest in the property for tax purposes thus not triggering a disposition. Under the new rules, a taxpayer who enters into an SDA will be deemed to have disposed of and reacquired the property immediately before the arrangement was entered into, therefore realizing any accrued gains or losses on the property at that time (refer to “SDA” section for more details). The stop loss rules will apply on the losses realized under the SDA rules whereby the taxpayer owning a property which is subject to the SDA rules will be deemed not to own the property while the arrangements are in place.

Straddle transactions

The 2017 budget introduces a new anti-avoidance rule to prevent taxpayers from accelerating the recognition of losses while deferring gains through the use of derivative transactions. These measures are similar to existing U.S. tax rules. “Straddle transactions” allow the taxpayer to selectively realize gains and losses on derivatives. To execute a basic straddle transaction, a taxpayer enters into two (or more) positions, (e.g., derivative positions) that are expected to generate equal and offsetting gains and losses. The taxpayer disposes of the position with an accrued loss before its taxation year-end to realize the loss. The position with an accrued gain is then disposed shortly after the beginning of the next taxation year. The taxpayer can use the loss to offset its other income, while deferring the recognition of the offsetting gain until the following taxation year.

The new stop-loss rule will effectively defer the realization of any loss on the disposition of a position to the extent of any unrealized gain on an offsetting position. For the purposes of the new stop-loss rule, a position is broadly defined and includes an interest in shares of corporation, a partnership or a trust, a commodity and foreign currency as well as derivatives and certain debt obligations. The stop-loss rule provides a number of exceptions. In particular, it will generally not apply to a position if:

- It is part of certain hedging transactions (i.e., certain foreign currency hedging or interest rate swap on debt) entered into in the course of the taxpayer’s business;
- It is held by the taxpayers who elect to use the new mark-to-market election on derivatives as proposed in the budget; or
- It is part of a transaction or a series of transactions, none of the main purposes of which is to avoid, reduce or defer tax.

The new rule will apply to any loss realized on a position entered into on or after March 22, 2017. Some investment funds that are neither mutual fund trusts nor mutual fund corporations may be impacted by the rules depending upon their trading strategies. Investment funds that meet the main purpose test exception should maintain documentation to support the non-tax reason for any trades that would otherwise be subject to the new rules as this will be a question of fact.
Suspended losses

The suspended loss rules found in The Income Tax Act, Canada (“the Act”) set out rules under which losses on certain dispositions of a capital property by a transferor or between affiliated parties are denied and suspended.¹⁰⁶

Technical application

Under subsection 40(3.3), the following three conditions must be met for the suspended loss rules in subsection 40(3.4) to apply:

1. A corporation, trust, or partnership disposes of a particular capital property
2. The transferor or an affiliated person acquires the property or identical property (“substituted property”) within a period beginning 30 days before and ending 30 days after the disposition (61-day period), and
3. At the end of the period, the transferor or an affiliated person owns the “substituted property”

If all three conditions are met, the transferor’s loss from disposition is deemed to be nil and the loss is suspended until the earliest of certain “triggering events.”¹⁰⁷

- The transferred property or identical property is subsequently disposed of to a person who is neither the transferor nor an affiliated person – The property including identical property has not been reacquired by the transferor or a person affiliated with the transferor within 30 days of the date of the subsequent disposition.

The suspended loss rules operate differently from the superficial loss rules. Unlike a superficial loss, a suspended loss does not increase the adjusted cost base (“ACB”) of the transferred property and does not become the loss to the transferee. Instead, the suspended loss remains with the transferor (a notional pool) until such time that the loss can be released upon one of the “triggering events” as described above. In other words, from the transferor point of view, the suspended loss rules alter the timing of the recognition of the losses.

Calculation of suspended losses

The Act does not prescribe a method for how to calculate the suspended losses. The CRA provides guidance on the release of suspended losses such that the release may be prorated on the basis of the number of items sold at a particular time, and the number of items acquired and retained in the 61-day period.
The CRA administratively accepts that the amount of a suspended loss may be determined by the following formula:

\[
\text{Suspended Loss} = \frac{\text{Least of (} S, P, \text{and } B)}{S \times L}
\]

Where,

- \(S\) = number of items disposed
- \(P\) = number of items acquired in the 61 day period
- \(B\) = number of items left at the end of the period
- \(L\) = loss on the disposition

Recently, the CRA noted in a Technical Interpretation\(^{108}\) ("TI") it upholds its long-standing position that since there is no mechanism in the Act for determining the order of disposition,\(^{109}\) a taxpayer can choose the order of disposition of shares.

**Compliance requirements**

Suspended losses must be tracked carefully as this may impact an investment fund's taxation liability and also a mutual fund's CGRM calculation. They should be calculated at the entity level and multi-series funds should consider how to identify and track suspended losses accurately.

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\(^{108}\) Income Tax Act (Canada) Subsections 40(3.3) and 40(3.4)

\(^{107}\) Ibid, Subparagraph 40(3.4)(b)(i) to (v)

\(^{108}\) CRA Technical Interpretation 2014-0529731E5

\(^{109}\) Income Tax Act (Canada) Subparagraph 40(3.4)(b)(i)
Corporate actions

A corporate action is a legal event initiated by a company that may have financial or non-financial consequences to investors in its equity or debt securities. There are many types of corporate actions each with potential tax consequences to investors. Some examples of corporate actions and their potential tax consequences are:

- Dividends and interest payments are taxable to the recipient (subject to any available deductions).
- A merger may or may not have tax consequences to investors depending on whether the companies have made certain tax deferral elections.
- A stock split may have tax consequences to investors depending on the residence of the corporation that initiated the stock split (e.g., a stock split by a Canadian resident corporation may be a non-taxable event, a stock split by a foreign corporation may be either a taxable or non-taxable event).

Some corporate actions such as name change have no direct financial impact on the shareholders. Below is a chart of common corporate actions that may arise, and the corresponding sections of the Income Tax Act, Canada (“the Act”) that address them.
Certain corporate actions that involve non-taxable distributions (i.e., return of capital) under certain foreign tax regimes may be characterized as taxable dividends or foreign income under Canadian regulations. Therefore, it is important to understand the legal form of the transaction and its respective corporate taxes under local jurisdictions in order to appropriately determine the Canadian tax implications, as errors may often result in a misstatement of an investment fund’s taxable income.

Information about corporate actions is made available to the public through management information circulars, various publications, and news releases. Larger portals providing such information include: Clearing and Depository Services (CDS) or its foreign equivalent; System for Electronic Document, Analysis, and Retrieval (SEDAR); and Electronic Data Gathering, Analysis, and Retrieval System (EDGAR).
Other income and deduction

The Income Tax Act, Canada (“the Act”) provides a mechanism for Other Income and Deduction (“OID”) that may be used by mutual fund trusts (“MFTs”). Where MFTs have made distributions in excess of the amount required to reduce their income tax payable to nil, MFTs may designate the excess amount to be income to their beneficiaries for the year. The additional income allocated by MFTs to their beneficiaries for the taxation year can be deducted for computing the income of the MFT in the following year. In the absence of the OID mechanism, an over-distribution would generally be treated as a return of capital distribution that would reduce the adjusted cost base of the units of beneficiaries.

The OID mechanism is only available for trusts that are MFTs throughout a taxation year and that have elected a December 15 taxation year-end. The OID mechanism cannot be used if the trust has designated an amount under subsection 104(13.1) of the Act (designation of allocated income deemed not to have been paid by a trust) or subsection 104(13.2) (designation of allocated capital gains deemed not to have been paid by a trust).

The Act imposes an anti-avoidance rule that denies the deduction of additional income allocated where it is reasonable to conclude that the decision to include income in the preceding taxation year was part of a series of transactions or events that included a change in the composition of beneficiaries (taxable versus tax-exempt) under the trust.
Application to asset management industry

Fund administrators may use the OID mechanism as a way of managing the risk of underestimating the amount of distributions required to reduce the MFT’s taxable income to nil. In practice, the OID mechanism is generally used when a time constraint exists between the December 15 taxation year-end and the time when a cash distribution is required, and where the MFT has a number of estimates used in the computation of its taxable income. One practical concern for beneficiaries that would arise, where the OID is applied, is that they would not benefit from the corresponding reduction to taxable income in the subsequent year when the OID is reversed if they are no longer beneficiaries at the end of that taxation year.

Compliance requirements

There is no prescribed form for MFTs to claim the OID. An MFT may make the OID designation within its tax return for the year. An MFT may be permitted, subject to permission granted by the Minister, to make, amend or revoke an OID election no later than the 10th calendar year from the initial taxation year in which the election was otherwise due to be made. A penalty for late filing is required up to a maximum of $8,000. 115

111 Income Tax Act (Canada) Subsections 132.11(6) to (8)
112 Ibid, Paragraph 53(2)(h)
113 Ibid, Subsection 132.11(6)
114 Ibid, Subsection 132.11(b)
115 Ibid, Paragraph 220(3.21)(b)
116 Ibid, Subsection 220(3.5)
Allocation of expenses

Under the Income Tax Act, Canada (“the Act”) expenses incurred by an investor or an investment fund should be examined to determine whether they are deductible in the determination of income or loss from a business or property.\(^\text{116}\) It should be noted that “income from property” does not include capital gains or losses arising from a disposition of property.\(^\text{117,118}\)

Where an investment fund characterizes its gains or losses on capital account then such expenses incurred by the fund may also be considered in the nature of capital, thus precluding their deduction from income.

Where expenses are incurred to earn income from a business or property, a taxpayer needs to consider items that are deductible in computing income for tax purposes.\(^\text{119}\)

The Exchequer Court in *Royal Trust* explained the scheme for the deductibility of expenses as follows:

> “Thus, it may be stated categorically that in a case under the *Income Tax Act* the first matter to be determined in deciding whether an outlay or expense is outside the prohibition of ... [paragraph 18(1)(a)] of the Act is whether it was made or incurred by the taxpayer in accordance with the ordinary principles of commercial trading or well accepted principles of business practice. If it was not, that is the end of the matter. But if it was, then the outlay or expense is properly deductible unless it falls outside the expressed exception of ... [paragraph 18(1)(a)] and, therefore, within its prohibition...”

To be deductible from revenue, an expense must satisfy six tests. It must:

1. Be of an income nature and not a capital expenditure;
2. Be reasonable in amount;
3. Be incurred for the purpose of earning income;
4. Not be a personal expenditure;
5. Not be expressly prohibited by the Act; and
Apart from these, there is no blanket public policy prohibition on deductibility of expenses.

The characterization of expenditures as current expenses or capital outlays is a question of mixed law and fact. The determination of the question depends not upon the nature of property acquired but upon the nature of the expenditure. For example what is the purpose why the taxpayer made the payment?

Where expenses have been incurred and such expenses, even proportionately, pertain to a capital outlay, such expenses are not deductible unless otherwise permitted under some other portion of the Act. For investment funds that earn income from property, and hold property on account of capital, the following sections of the Act permit deduction of certain expenditures.

**Interest deductibility**\(^{121}\) – Generally, interest expense is considered to be a capital expenditure. Accordingly, specific provisions of the Act must be met in order for interest to be deductible, the amount must be paid pursuant to a legal obligation, must be reasonable, and the money borrowed must be used for earning income.

**Investment counsel fees**\(^{122}\) – expressly permits a taxpayer to deduct fees paid for advice on buying or selling a specific share or security or for services in respect of the administration or management of the taxpayer’s shares or securities, provided the fees are paid to a person or partnership, the principal business either of which is advising others on purchasing or selling specific shares or securities or includes the provision of such administrative or management services.

**Financing fees**\(^{123}\) – The purpose is to permit the amortization, over a five-year period, of certain financial expenses relating to the issue or sale of shares, units of unit trusts, or partnership or syndicate interests, or relating to the borrowing of money, all of which would otherwise be regarded as non-deductible capital expenditures. Generally, such expenses would include legal, accounting and other expenses relating to the financing, other than interest costs relating to a borrowing of money, and would be deductible at the rate of 20 per cent for a full fiscal period of 365 days over a five-year period.

**Share transfer and other fees**\(^{124}\) – Allows for the deduction of share transfer fees, listing fees, and the cost of printing financial reports.

### Expenses of representation\(^{125}\)

Specifically provides that representations made to a government or agency of a government made for the purpose of obtaining a license, permit, franchise or trade mark relating to the taxpayer’s business are deductible. If such representations are successful, and such an asset is in due course acquired, it may constitute property described in Class 14 of Schedule II to the Regulations.

Subject to a fund’s investment strategy, legal entity status and deductibility limitations, eligible expenses are generally deducted from income categories that are taxed at a higher rate (i.e., ordinary income or foreign dividends) before being deducted from more favourably taxed income categories such as capital gains or Canadian eligible dividends.

In some instances, where expenses are utilized to reduce taxable income before distributions to investors, this may give rise to Alternative Minimum Tax (AMT) for individuals, particularly for unit trusts that are not mutual fund trusts (“MFTs”). Although AMT is refundable against future taxable income, it still represents a cash flow drag on yield for investors: Careful planning should be undertaken to minimize AMT wherever possible.

Also where possible, and in accordance with the anti-avoidance provisions of the Act, investment funds should consider the nature of their investor profile when determining the impact of making distributions to unit holders.

### Deductibility of expenses for tax-deferred plans (RRSP/RRIF/TFSA)

Recent draft comments from the CRA provide insight into CRA’s anticipated clarification of administrative positions relating to the deductibility of certain investment management fees incurred by registered and/or non-registered plans holding interests in funds. There are differing tax implications based on the type of investment expense in question, the circumstances surrounding the expense, and the entity that ultimately pays the expense.

#### 1. Rebates of commission

Mutual fund dealers often offer incentive programs to investor clients, in which they share certain commissions received in connection with the operation of the fund. When the rebate relates to a registered plan, it may be paid into the plan with no adverse tax consequences.
However, if the rebate involves an individual who has multiple accounts, it must be allocated on a pro-rata basis across both registered and non-registered accounts. For example, an arrangement that diverts a rebate into only registered accounts will trigger the advantage rules in subsection 207.01(1), ultimately imposing tax based on the FMV of the “advantage” received. See below for a summary of the advantage rules.

2. **Investment management fees** – Investment management fees relate to expenses of a registered plan that relate to administration or management of the securities held in the plan. Previously, CRA had an administrative policy that allowed either the registered plan or the controlling individual\(^\text{126}\) to pay these costs.

However, effective January 1, 2017, CRA announced that they now consider payment of these expenses by a controlling individual to constitute an “advantage” which will trigger adverse tax consequences to the individual. Note that any fees reasonably related to a period before January 1, 2017 can still be paid by either the plan or controlling individual.

3. **Investment counsel fees** – Investment counsel fees relate to advice obtained in the purchase or sale of investments in the registered plan, and are generally considered to be an expense of the plan’s controlling individual.

CRA has a long-standing administrative policy that permits the registered plan to pay the expenses without the controlling individual falling within the “advantage” rules. The fees must reasonably relate to the investments in the plan to fall within this scope. Currently, the policy remains unchanged.

This is of particular relevance when there are comprehensive fees payable which consist of both investment counsel and investment management fees, and there are practical difficulties in apportioning the fee to each category. In this situation, the fee can be paid by the registered plan without any tax consequences or requirement to identify the breakdown of the expense.

4. **Transaction fees** – Transaction costs are expenses of a registered plan that are related to: the disposition or acquisition of investments, valuation costs, commissions, redemption charges, switch fees, withdrawal fees, and other transaction fees relating to the plan. This type of expense must be paid using the plan funds; payment of these expenses by the controlling individual will constitute an “advantage” under subsection 207.01(1), and trigger adverse tax consequences.

5. **Administration fees** – Fees relating to the overall direction and management of a registered plan are deductible when paid using funds held in a plan, or by the plan’s controlling director. The CRA has clarified that there will be no adverse tax consequences in the above mentioned scenario.

CRA’s interpretation and administrative position for the investment fees discussed above are currently still in draft format; a formal income tax folio is expected in 2017.

**Advantage rules – ss.207.01**

The term “advantage” is defined in subsection 207.01(1), and refers to certain circumstances that occur in relation registered plans, including RRSPs, RRIFs, and TFSAs. An advantage will arise in different situations, including when the FMV of the property held in the registered plan has increased in a situation that is not reasonably expected to occur in an open market.

When an advantage arises, subsections 207.05(1) and 207.05(2) impose a tax payable by the controlling individual on the fair market value of the advantage conferred. Note that subsection 207.05(3) transfers the tax liability to the issuer or carrier of the plan if the advantage was extended by that party.

\(^{116}\) Income Tax Act (Canada) Subsection 9(1)  
\(^{117}\) Ibid, Subsection 9(3)  
\(^{118}\) see Section 29 of the Act  
\(^{119}\) Ibid, Section 20  
\(^{120}\) Income Tax Act (Canada) Paragraph 18(1)(b)  
\(^{121}\) Ibid, Paragraph 20(1)(c)  
\(^{122}\) Ibid, Paragraph 20(1)(bb)  
\(^{123}\) Ibid, Paragraph 20(1)(e)  
\(^{124}\) Ibid, Paragraph 20(1)(g)  
\(^{125}\) Ibid, Paragraph 20(1)(cc)  
\(^{126}\) A “controlling director or individual” is the annuitant of an RRSP/RRIF, or the TFSA holder.
Financial institutions

An entity that is recognized as a financial institution (“FI”) for tax purposes is subject to unique tax implications. For example, the income of an FI is calculated under mark-to-market (“MTM”) rules where unrealized gains and losses are treated on account of income.

Meaning of financial institution

The Income Tax Act, Canada (“the Act”) defines an FI to include, by reference, those activities listed under the definition of a restricted financial institution as defined by the Act. Generally, FIs would include banks, trust companies, investment dealers, credit unions, insurance corporations, and corporations the principal business of which is lending money or purchasing debt, and corporations controlled by any of the above-mentioned entities. Mutual fund corporations are excluded from the definition of an FI.

A trust (except for a mutual fund trust) or a partnership, is also an FI if more than 50% of the fair market value of all interest in the trust or partnership is owned by an FI.

Tax implications

Generally, an FI is required to have certain properties marked to market for tax purposes. These fall under the definition of “mark-to-market property” (MTM) and include holdings of shares, certain specified debt obligations (SDO), and tracking property. There are some specific exclusions, such as shares of a corporation in which an FI has a significant interest, or qualified small business corporation shares.

An SDO may include fixed-income instruments such as loans, bonds, debentures, and mortgages.

Tracking property is defined as a property with a fair market value (FMV) determined primarily by reference to one or more criteria in respect of another property that, if owned by an FI directly, would be considered a MTM property. Common examples of tracking property include mutual fund trusts, unit trusts, and equity derivatives.

An FI must recognize unrealized gains and losses on MTM property as income or losses immediately for tax purposes, whether held or disposed. Any accrued gains and losses on MTM property are generally considered on income account rather than on capital account unless certain conditions are met.
Change in financial institution status

Where a taxpayer is no longer regarded as an FI under the Act, a year-end is deemed to occur. This is also the case when a taxpayer becomes an FI under the Act. Where a taxpayer becomes an FI under the Act, a new tax period is considered to begin and a new tax ending period may be selected. Where a deemed year-end arises, the taxpayer (except for a mutual fund trusts electing under 132(6.1) of the Act) is deemed to dispose of and reacquire all of its property at FMV.

127 Income Tax Act (Canada) Subsection 248(1)
128 Financial Institution is defined under Income Tax Act (Canada) Subsection 142.2(1)
129 Significant interest is defined ibid, 142.2(2)
130 SDO is defined ibid, 142.2(1)
131 SDO inclusions per ibid, paragraphs 142.2(1)(a) and (b)
132 The change in FI status is outlined Income Tax Act (Canada) Subsection 142(6)
Dividend tax credit

Dividend income is derived from investments in shares of dividend-paying corporations. When a mutual fund trust (“MFT”) earns and distributes dividend income to a Canadian resident, that income is generally included in the investor’s income as income from property, except when a deeming provision applies. One such deeming provision allows dividend income earned by the trust to be taxed as dividend income to investors.  

Taxation of dividend income

Dividend income received by an MFT is taxed through a gross-up and tax-credit mechanism. The purpose is to prevent the double taxation of corporate income. When dividends are paid, the funding source of the dividends is usually after-tax retained earnings of the payer corporation. If a recipient were to pay tax on the dividends received at the marginal tax rate, the income that gave rise to the dividends would effectively be taxed twice. The dividend gross-up and tax credit mechanism will reduce, at the individual taxpayer level (including MFTs), the potential double taxation of income generated by a corporation.

The dividend tax credit (“DTC”) is an important building block to achieve integration in the Canadian tax system. In the context of corporations and their shareholders, under a perfectly integrated tax system the total tax burden should be identical whether the individual receives the income directly as a shareholder or indirectly via a corporate structure.

In essence, the gross-up is intended to add to the dividend received by the shareholder an amount equal to the total income tax paid by the corporation on the income that gave rise to the dividend. Thus, the grossed-up dividend represents the corporation’s pre-tax income. Tax liability of the recipient is calculated based on the grossed-up dividend income at the recipient’s marginal tax rate, and then a DTC is applied to give credit for the tax paid by the corporation on the shareholder’s behalf. Essentially, the DTC should represent the underlying tax paid by the corporation.
Eligible dividends vs. ineligible dividends

Dividends are classified as eligible or ineligible. Different rates for gross-up and tax credit are used depending on the type of the dividends. In general, eligible dividends are dividends paid by a corporation that is taxed at the general corporate rate, whereas ineligible dividends are dividends paid by a corporation that is taxed at the low corporate rate. Recipients of eligible dividends are entitled to an enhanced dividend gross-up and DTC, representing the higher corporate tax rate paid by the payer corporation.

133 Income Tax Act (Canada) Subsection 104(19)
134 Ibid, Section 121
Interest income

Interest income is recognized as taxable income in the year accrued to the taxpayer. Although the property to which the interest income is related is often capital property, interest is specifically included on account of income.¹³⁵

"Interest" is not defined in the Income Tax Act, Canada ("the Act") but guidance about the meaning of the term has been addressed in several court decisions, including *Shell Canada Limited v The Queen* (1999), *The Queen v Sherway Centre Ltd.* (1998), and *Miller v The Queen* (1985).

As a result of this jurisprudence, interest for tax purposes is generally accepted to mean an amount that has met the following three criteria:

1. It represents compensation for the use of money.
2. It is calculated in reference to a principal sum.
3. It accrues day-to-day.

Where a contract or arrangement does not specifically identify an amount as interest but the amount can reasonably be considered interest according to accepted criteria, that amount is deemed to be interest for both parties to the contract or arrangement.¹³⁶

Income recognition

**Corporations, partnerships and certain trusts**

A corporation, partnership, unit trust, or any trust that has a corporation or partnership as a beneficiary, includes interest on most debt obligations. That interest is included in income when it has accrued to the taxpayer in the current tax year, or when the interest was received or became receivable by the taxpayer, to the extent that it has not been previously included in the income of the taxpayer.¹³⁷

Interest from an income bond, an income debenture, a small business development bond or a small business bond is not subject to these timing rules, and follows the timing described for other taxpayers below.¹³⁸
Other taxpayers

For other taxpayers, interest is included in income when received or receivable. However, for an “investment contract,” an amount must be recognized on the anniversary date of the obligation (or the date of disposition) equal to the amount of interest accrued up to that time.\(^\text{139}\)

An “investment contract” is any debt obligation that is not:\(^\text{140}\)

− A salary deferral arrangement, as well as certain obligations specifically excluded from the definition of salary deferral arrangement in the Act

− A retirement compensation arrangement, as well as certain obligations specifically excluded from the definition of retirement compensation arrangement in the Act

− An employee benefit plan

− A foreign retirement arrangement

− An income bond

− An income debenture

− A small business development bond

− A small business bond

− An obligation for which an individual has earned interest on an annual or other basis, provided the individual has included the accrued interest in income at least annually

− An obligation in respect of a net income stabilization account

− An indexed debt obligation

− A prescribed contract

Any taxpayer who has deducted a reserve for doubtful debts in computing taxable income should not include interest in the computation of taxable income for the part of the year the obligation is impaired.\(^\text{141}\)

Deemed interest

The deemed interest rules apply to an interest amount when computing a taxpayer’s income for prescribed debt obligations of the following types\(^\text{142}\):

− An obligation for which no interest is stipulated to be payable on the principal amount (e.g., zero coupon bonds)

− An obligation for which the taxpayer is entitled to be paid a proportion of principal that differs from the proportion of interest to which the taxpayer is entitled (e.g., stripped bonds)

− An obligation for which it is known, at the time of acquisition by the taxpayer, that the maximum amount of interest payable in a year after that time is less than the maximum amount of interest payable in a subsequent year (e.g., step-up bonds or escalating term deposits, where the interest payable increases over the term of the obligation)

− An obligation under which the amount of interest to be paid for a tax year depends on a contingency existing after the year has ended

The Act provides formulas to calculate the deemed interest to be recognized in respect of each of these prescribed debt obligations.

There are similar rules in the Act that address the amount of interest income to be recognized in respect of Indexed Debt Obligations for which the stated interest rate changes in correlation with the purchasing power of money\(^\text{143}\) as well as obligations issued at a discount from face value.\(^\text{144}\)

Interest payments to non-residents

Generally, withholding tax does not apply to interest payments made to non-residents unless it is interest that:

− Is not fully exempt interest (as defined by the Act) and paid or payable to a non-arm’s length person, or

− Is participating debt interest\(^\text{145}\)
“Participating debt interest” is generally interest (other than certain fully-exempt interest) that is contingent or dependent on the use of or production from property in Canada, or is computed in reference to revenue, profit, cash flow, commodity price or any other similar criterion, or by reference to dividends paid to shareholders of the capital stock of a corporation.\textsuperscript{146}

Payments from a trust are not considered to be interest for purposes of withholding tax regardless of whether the trust has earned interest income. Therefore, payments of trust income to a non-resident are subject to withholding tax of 25\%.\textsuperscript{147} The withholding tax rate may be reduced when the recipient is entitled to benefits under a tax treaty entered into by Canada and the recipient’s country of residence.

\textsuperscript{136} Income Tax Act (Canada) Paragraph 12(1)(c)
\textsuperscript{137} Ibid, Subsection 16(1)
\textsuperscript{138} Ibid, Subsection 12(3)
\textsuperscript{139} Ibid
\textsuperscript{140} Ibid, Subsection 12(4)
\textsuperscript{141} Income Tax Act (Canada) Subsection 12(4.1)
\textsuperscript{142} Ibid, Subsection 12(9) and regulation 7000
\textsuperscript{143} Ibid, Subsection 16(6) and regulation 7001
\textsuperscript{144} Ibid, Subsection 16(2) and (3)
\textsuperscript{145} Ibid, Paragraph 212(1)(b)
\textsuperscript{146} Income Tax Act (Canada) Subsection 212(3)
\textsuperscript{147} Ibid, Paragraph 212(1)(c)
Trust loss restriction events

In December 2013, the Department of Finance ("Finance") introduced trust loss restriction rules aimed at preventing tax loss trading transactions. These rules extend existing loss-streaming and related acquisition of control rules to trusts where a trust becomes subject to a loss restriction event ("LRE").

Generally, an LRE is considered to occur for a trust whenever a person or group of persons acquires more than 50% of the fair market value ("FMV") of the income or capital interests in a trust and becomes a majority-interest beneficiary or group of majority-interest beneficiaries. For the purpose of determining whether a particular trust is subject to an LRE, there are certain exceptions that generally apply to transfers or acquisitions of trust equity within an affiliated group of persons or other specific circumstances.

One exception of note relates to circumstances in which a taxpayer becomes a majority interest beneficiary as a result of another beneficiary’s redemption of units. In a December 23, 2014 comfort letter, Finance clarified that an exception is intended to apply under these circumstances. The Department proposed to recommend amending the legislation to expand the exception for a person or group of persons not to become a majority-interest beneficiary or group of majority-interest beneficiaries solely because of redemption by another investor. As discussed in Section IV, there are also additional requirements that must be met in order for this proposed exception to apply.

Subsequent amendments

Following the introduction of the loss restriction event rules for trusts, Finance introduced two sets of amendments to the legislation to carve out certain commercial investment funds from the application of the rules. The latest amendments were included under Bill C-29 and were enacted on December 15, 2016 and are effective as of March 31, 2013. These legislative updates provide that the acquisition or disposition of equity in a trust that is immediately before that time an "investment fund" (formally termed as a Portfolio Investment Fund, and was repealed under Bill C-29) will not cause a person or group of persons to have considered to have become a majority-interest beneficiary or group of majority-interest beneficiaries in the trust. The result is subject to the requirement that the acquisition is not part of a series of transactions or events under which the trust ceases to qualify as an "investment fund".
There are two sets of requirements for a trust to be qualified as an “investment fund”. In general terms:

1. First, there must be an outstanding class of units of the trust that has been qualified for distribution, or lawfully distributed, to the public as described in paragraph 4801(a) of the Income Tax Regulations. This requirement must be met at all times throughout the period that begins at the end of the calendar year in which the trust was created.

2. Second, the trust must be a non-discretionary unitized trust that is factually resident in Canada and must satisfy all of the following conditions. At all times the trust must:
   a. Follow a reasonable policy of investment diversification
   b. Limit its undertaking to investing
   c. Not hold property that is used in carrying on a business or that is real property or resource property
   d. Not legally control, alone or as part of a group, a corporation
   e. Not hold more than 20% of any class of securities of an issuer, unless:
      i. The equity securities held by the trust have a total fair market value that is more than 10% of the equity value of the issuer, and
      ii. The debt securities held by the trust have a total fair market value that is more than 10% of the fair market value of all the liabilities of the issuer.

This amendment was in response to the industry’s request to expand the relief from the loss restriction event legislation for commercial investment funds which previous legislation still inadvertently left many investment funds subject to. However, despite these welcome changes, there still may be a relatively small population of commercial investment funds that are subject to an LRE. Examples of scenarios where commercial investment funds may fall offside of the relief are as follows:

- The requirement to be considered an “investment fund” is currently based on meeting the terms “at all times” from the later of March 21, 2013 and the end of the calendar year in which the trust was created or ends. As such, certain new investment funds, depending on their creation date, may still find themselves in circumstances in which they are subject to the application of the LRE rules.
- The legislation requires an investment fund to follow a reasonable policy of investment diversification and restricts investment concentration to less than 20% in any one class of an issuer’s securities, and less than 10% in an issuer entity’s equity value or liabilities (excluding another investment fund). The current legislation does not define what constitutes a diversified portfolio of securities. In addition, investments in other investment funds that are non-resident of Canada could, under certain scenarios, still be subject to the LRE rules.

**Compliance requirements**

If a LRE occurs, an investment fund that is a trust may be subject to tax consequences, including:

**Deemed tax year-end**

The trust will have a deemed tax year-end at the beginning of the day on which the LRE occurs unless the trust elects in its return of income to have its tax year-end immediately before the time at which the LRE occurs. From a tax compliance perspective, where a trust is subject to an LRE, the due date for filing a T3 trust return and related T3 slips is the due date had the trust not been subject to the LRE (i.e., 90 days after the trust’s tax year-end had it not been subject to LRE). The trust’s balance-due date for the stub year is also extended to that day.

**Realization of all accrued but unrealized losses**

A trust will be required to realize any accrued losses on capital property that expire at the date of the LRE. The trust may elect to realize accrued capital gains to offset the accrued losses.

**Limitation of unused loss carryforwards and carrybacks**

The ability of a trust to use any unused losses carried forward before the LRE is restricted depending on the type of loss:

1. **Capital losses** – Capital losses that are not utilized will expire immediately and not be available for periods after the LRE.
2. **Property losses** – Similarly, losses arising in connection with the earning of income from property will expire immediately upon an LRE.
3. **Non-capital losses** – Non-capital losses remaining after an LRE can be carried forward, but only to the extent of income or profits generated from the same or similar business that may reasonably be regarded to give rise to such loss. The trust will be unable to carry back any net capital losses and property losses realized after the LRE to periods before the LRE.
Key considerations for investment funds

- Fund managers and administrators should consider whether any of their existing products fail to meet the exception for an investment fund based on the proposed amendments. Once investment funds not covered by the exception are identified, procedures should be considered to monitor the investors in their funds and identify situations where an LRE occurs. The risk and implication of an LRE should be discussed in a fund offering memorandum or prospectus.

- In the event that a LRE occurs, consideration should be given to the tax loss attributes of the funds and whether any action(s) should be undertaken in order to minimize the expiration of those losses. For example, a capital gain could be triggered on an LRE to utilize the capital loss that would otherwise expire as discussed above.

148 Income Tax Act (Canada) Subsection 251.2(2)
149 Ibid, Subsection 251.2(3)
150 Income Tax Act (Canada) Subsection 251.2(3)(f)
151 Income Tax Act (Canada) Subsection 251.2(6)
152 Ibid, Subsection 251.2(7)
153 Ibid, Paragraphs 111(4)(c) and (d)
154 Ibid, Subsections 111(4) and 111(5)
Alternative minimum tax

The alternative minimum tax (AMT) is a separate tax calculation of a net minimum tax payable that is performed in parallel with an entity’s regular income tax calculation. The purpose of AMT is to ensure individuals and certain trusts that would otherwise pay little or no tax as a result of tax deductions (i.e., tax exempt gains) afforded under the Income Tax Act, Canada (“the Act”) pay a minimum amount of tax. In respect of trusts, the computation of AMT is found on Schedule 12 of the T3 Trust tax return.

Who is subject to AMT?
Generally, AMT applies to individuals and certain trusts resident in Canada, including deemed residents and non-residents who earn Canadian-sourced income. Exemptions from AMT apply to certain trusts (e.g., mutual fund trusts).

Calculation of AMT
The calculation of AMT consists of two components: (1) an adjusted taxable income and (2) net minimum tax payable. The taxpayer is required to pay federal tax equal to the greater of the net minimum tax and the net federal tax.

1. Adjusted taxable income
   The base of AMT is the adjusted taxable income for which the tax benefits derived from various tax preferential items that an individual or trust might have received in the year are added back to the standard taxable income. Some common tax item adjustments include: taxable capital gains, dividends received from Canadian corporations, use of tax losses, investment tax credits, etc.

2. Net minimum tax payable
   The AMT for a trust is 15% of the adjusted taxable income for 2016. Certain tax credits are allowed against this payable account.
Other relevant information

A trust may carry forward the difference between AMT and the standard taxable amount to reduce standard tax payable in a subsequent tax year, subject to certain conditions. The AMT can be carried forward a maximum of seven tax years. It should be noted that as an investment trust is generally a flow-through non-taxable vehicle, the payment of AMT would represent a tax cost to investors and therefore impact the overall yield on investments held by the trust. It is generally recommended that investment trusts monitor potential AMT liabilities on an interim basis to undertake planning alternatives that would reduce or eliminate this tax.

155 Adjusted taxable income determined per Income Tax Act (Canada) Section 127.52(1), and is subject to subsection (2)
156 Minimum tax rate of 15% is the lowest rate per Income Tax Act (Canada) Paragraph 117/2(ii)
Investment fund mergers

During a fund merger, a terminating fund will generally transfer its investment portfolio to a continuing fund. As consideration for the transfer of the non-continuing fund’s investment portfolio, that fund will receive units/shares from the continuing fund equal to the fair market value (“FMV”) of the portfolio transferred. The newly acquired units/shares of the continuing fund are then distributed to the non-continuing fund’s investors and their former units/shares are then cancelled.

Absent any tax-free rollover provisions in the Income Tax Act, Canada (“the Act”), a fund merger would result in a taxable event, including the disposition of the non-continuing fund’s portfolio and, for investors, the disposition/cancellation of their units in the non-continuing fund. The Act permits a tax-deferred merger known as a “qualifying exchange” that allows the transfer of the non-continuing fund properties to the continuing fund on a tax-deferred basis. Units/shares of the continuing fund would then be exchanged for the units/shares of the terminating fund on a tax-deferred basis.

Tax-deferred mergers are useful when their objective is to:

- Combine two or more funds with similar objectives/portfolios
- Weed out small or declining funds
- Increase the size of a fund to diversify through economies of scale
- Reduce fixed administrative costs by merging funds

**Technical application**

To recognize the merger on a tax-deferred basis, rules under the Act must be met. Under section 132.2, a qualifying exchange means a transfer at any time of all or substantially all of the property of a mutual fund corporation (“MFC”) or mutual fund trust (“MFT”) to an MFT if:

- All or substantially all of the shares issued by the non-continuing fund and outstanding immediately before the transfer time are disposed of within 60 days after the transfer time
No person disposing shares of the non-continuing fund within that 60-day period (notwithstanding the exercise of a statutory right of dissent) receives any consideration for the shares other than units of the continuing fund.

Funds jointly elect to merge by filing a prescribed form to the CRA on or before the election's due date (within 6 months of the transfer time).

If all criteria are met, the non-continuing fund may elect to merge and the continuing fund may designate an amount of deemed proceeds (between cost and FMV) to minimize the current tax impact. However, the funds may elect to merge and designate amounts to recognize capital gains to utilize non-transferrable expiring losses from the non-continuing fund, such as:

- Current year losses
- Losses deemed to arise on the transfer of the non-continuing fund, and deemed disposition of non-continuing fund assets
- Loss carryforwards in both funds
- Suspended losses in both funds, which will be fully released on merger
- Retained capital gains to use available Capital Gains Refund Mechanism ("CGRM") for the transfer year

The general rules for designating and electing can be found under section 132.2(3) of the Act. Fund mergers can be quite complex and require careful consideration. It may not always be ideal for an MFT to undertake a tax-deferred merger; therefore, consider professional assistance from external tax advisors to analyze the specific situation.

**Tax-deferred merger of segregated funds**

Segregated funds are life insurance policies that share many common characteristics with mutual fund trusts. To create a level playing field, the 2017 federal budget proposes to allow insurers to merge segregated funds on a tax-deferred basis, and these rules are generally parallel to the merger rules applicable to mutual fund trusts and corporations.

Under the proposed rules, two segregated funds may merge on a tax-deferred basis, provided that there is a qualifying transfer of funds. A qualifying transfer of funds is defined as a transfer at any time where:

- All of the property of a related segregated fund (transferor) becomes the property of another related segregated fund (transferee);
- The beneficiaries of the transferor receive no consideration for their interest in the transferor other than an interest in the transferee as a result of the transfer;
- The trustee of the funds is a resident of Canada; and
- The trustee of the funds so elects, by filing a prescribed form with the Minister of Revenue on or before the election's due date.

The election due date is proposed to be the later of six months after the transfer date, or a date specified by the Minister of Revenue.

If all of the criteria are met, the property of both segregated funds will be deemed to have been disposed of immediately before the transfer time, and subsequently reacquired at the transfer time. The funds may designate an amount of deemed proceeds (between cost and FMV) to minimize the current tax impact.

This measure will apply to qualifying transfers that occur on or after January 1, 2018.

[1] Income Tax Act (Canada) Section 132.2
Foreign tax matters
Foreign withholding taxes

An investment fund ("trust") may earn income from many different sources. When income is earned on foreign investments, it may be subject to foreign withholding taxes based on the tax laws of the source country and applicable tax treaty with Canada.

In the case of an investment fund structured as a trust, there are generally two options to consider for the tax treatment of foreign withholding taxes paid on foreign source income:

1. Deduct the foreign withholding taxes against the foreign income earned, and distribute the net income to beneficiaries. The foreign income allocated to the beneficiary would retain its character (e.g., dividends, interest).

2. Elect to designate both the income from a foreign source and the related foreign taxes as paid to the beneficiary. The beneficiary would therefore be taxed on the gross foreign income and utilize, where possible, a foreign tax credit to reduce its federal income tax payable.

It should be noted that any foreign taxes that arose in respect of capital gains are generally not eligible for any of the two options above. In addition, in order to qualify for the FTC, the amount paid to the foreign government must be compulsory (i.e., it must be required to be paid). Therefore, in the case where the trust has not undertaken to reclaim the withholding taxes at source, to the extent a lesser tax rate under an applicable tax treaty is available, such deductions for any excess foreign taxes paid may otherwise be denied.

The calculation of the FTC is computed by the lesser of the following two formulas prescribed by the Act:

1. Total amount of foreign taxes paid for the year to a government of a foreign country, and
2. The proportion of Canadian tax that would otherwise be payable for the year on all qualifying incomes (net of losses) from sources in the foreign country relative to the taxpayer’s worldwide income for the year.

To designate the foreign income, the trust would elect under the Income Tax Act, Canada ("the Act"). Per subsection 104(22) of the Act, the amount of the designation to a particular beneficiary is limited to the trust’s foreign source income that:

1. Is not designated by the trust to another beneficiary, and
2. May reasonably be considered to be part of the amount that was included in the beneficiary’s income.
Once this designation is made, the foreign tax credit rules under section 126 apply to the beneficiary to claim a FTC. The beneficiary’s pro-rata share of the foreign business-income tax and non-business-income tax is used in calculating the beneficiary’s foreign tax credit.\textsuperscript{168}

If the beneficiary of a trust is another trust and a subsection 104(22) election has been made, the beneficiary trust may designate the foreign source income to its own beneficiaries. The designation flows down \textit{ad infinitum} to the extent that beneficiaries are trusts themselves.

It is key to note that the designations in subsection 104(22) do not apply for the purpose of subsections 20(11) or 20(12). Therefore, any unutilized foreign tax credits would not be deductible in computing income of the beneficiary.\textsuperscript{169} Additionally, a taxpayer may only claim a foreign tax credit equal to the lesser of the amount of the tax paid for the year to a government of a foreign country and the portion of Canadian tax otherwise payable for the year that relates to the person’s income from that country. To qualify for the foreign tax credit, the amount paid to the foreign government must be compulsory (i.e., it must be required to be paid). Therefore, in the case where an investment fund that has not undertaken to reclaim the withholding taxes at source, to the extent a lesser tax rate under an applicable tax treaty is available, such deductions for any excess foreign taxes paid may otherwise be denied.

In the case of an investment fund structured as a corporation, such as a mutual fund corporation ("MFC"), subsection 20(11) of the Act would not be available, as it is only available to individuals, including trusts. An MFC may consider applying the provision of subsection 20(12) in its determination of its taxable income. Non-business income tax that has been deducted by virtue of subsection 20(12) is excluded from non-business income tax for purposes of paragraph 126(7)(c). That is, a deduction under subsection 20(12) requires an equivalent reduction in respect of the relevant foreign business-income tax and non-business-income tax amount that is used in calculating the amount of foreign tax credit that may be claimed, and the amount of net income used in that calculation. It should be highlighted that a subsection 20(12) deduction results in tax relief at the effective tax rates, while section 126 relief is usually available on a dollar-for-dollar basis. Similar restrictions would apply for an MFC in the case where it is a beneficiary of an underlying investment trust; therefore, any foreign withholding taxes allocated may represent an even greater cost to the MFC on its foreign source income.

**Compliance requirements**

Foreign tax credits ("FTCs") must be calculated per country, so a fund with many foreign investments may find it more practical to deduct foreign taxes paid rather than allocating them to their unit holders.

Consideration should be given to the type of unit holders who hold units in the trust and whether it would be beneficial to flow the credits through.

A subsection 104(22) election is made in the trust’s income tax return for the year. The Canadian dollar equivalent of the beneficiary’s share of the deemed foreign source income and the related business income tax or non-business income tax is reported on the beneficiary’s T3 Supplementary.\textsuperscript{170}

In the event of an incomplete or incorrect designation, CRA has taken the administrative position of allowing the trust to submit an updated designation or provide the missing information.

The trust, in calculating its own FTC, must deduct the total of all amounts designated to its beneficiaries.\textsuperscript{171}

\textsuperscript{168} [IT-201R2 paragraph 5]

\textsuperscript{169} [Ibid, Paragraph 104(22)(d)]

\textsuperscript{170} [Income Tax Act (Canada) Subsection 104(22) and 104(22.3)]
Non-resident investment funds

A number of provisions under the Income Tax Act, Canada ("the Act") are intended to prevent Canadian residents from deferring or avoiding tax by investing in non-resident investment funds. The implications of these rules vary and, in certain situations, can result in a non-resident investment fund being subject to Canadian taxation. Generally, if the deemed resident rules do not apply, the Act might still subject Canadian investors to imputed income or the foreign accrual property income ("FAPI") regime.

Deemed resident

Certain non-resident trusts may be deemed to be resident of Canada where there is a Canadian resident contributor or beneficiary in the trust. There are a number of exceptions to this deeming rule and foreign commercial investment funds with Canadian investors should ensure they qualify. Where the exceptions are not met, a non-resident investment fund may be deemed to be resident in Canada under the Act and therefore subject to tax on its earned income worldwide. In cases where the provisions of section 94 arise, the non-resident trust may file an election to pay tax in Canada on income earned from property owned or contributed by a person who is a resident of Canada. Each person who is a Canadian resident contributor or beneficiary of the trust is then jointly and severally liable with the trust for the applicable Canadian taxes.

Offshore investment fund property

Where the provisions of section 94 of the Act do not apply, a Canadian taxpayer may still be required to include income earned by the non-resident fund for tax purposes on an accrual basis under section 94.1 of the Act, where

- A taxpayer holds a share, interest or debt of a non-resident entity
The share, interest or debt held by the taxpayer may be reasonably considered to derive its value primarily from certain “portfolio investments.”

It may be reasonably concluded that one of the main reasons for the taxpayer to acquire, have or hold such property is to derive a tax benefit; that is, taxes from the portfolio investments for any particular year are significantly less than they would have been had the taxpayer directly earned the income, profits or gains from the portfolio investments.

Where the conditions for the application of subsection 94.1(1) are met, the taxpayer is required to accrue imputed income for the year based on “designated cost” in the offshore investment fund at the end of each month, multiplied by the prescribed rate of interest under Part XLIII of the Regulations for the relevant period, plus 2%, to the extent that this imputed income exceeds actual income derived from the investment not including capital gains. The “designated cost” of an offshore investment fund property is the total of the cost amount of the property plus the deemed income inclusion from each previous year. As an example, the prescribed interest rate for all four quarters of 2015 was 1%; therefore, the imputed income will be calculated as the “designated cost” multiplied by 3%.

The amount of the income inclusion under subsection 94.1(1) is added to the adjusted cost base (“ACB”) of the investment and therefore reduces any future capital gain (or increases a capital loss) on the future sale of the investment.

For section 94.1 to apply, it must be determined that one of the main reasons for investing in the offshore investment fund is the tax benefit received by the investor. The analysis must consider all circumstances, including the nature of the investment fund and its terms and conditions, the degree to which tax has been reduced on income, profits, and gains, and the extent to which the entity distributes income, profits, and gains.

The CRA takes the position that section 94.1 would generally apply to a Canadian taxpayer investing in a mutual fund resident in a “tax haven country,” stating:

“Based on case law on the ‘one of the main reasons’ test in other provisions of the Act, it is our view that tax reduction or deferral does not have to be the only reason, or even the main reason, for the investment; it merely has to be one of the main reasons. A particular fund manager’s expertise may be another of the main reasons for the investment. The onus is on the taxpayer to prove that none of the main reasons for the investment is tax reduction or deferral.”

Prior to the summer of 2016, case law had not provided interpretative guidance as to the “main reason” test. However, in the recent case of *Gerbro Holdings Company v. The Queen* (2016) regarding the application of section 94.1, the Tax Court of Canada decided in favour of the taxpayer finding that although significant tax savings were realized, they were an ancillary consideration and did not necessarily elevate that motivation to a “main reason” given the overall non-tax evidence for the investment presented in the case.

**Non-resident commercial trusts**

Section 94.2 of the Act is a fairly recent addition that applies to tax years ending after March 4, 2010. However, for tax years that end before October 24, 2012, a transitional rule limits the application of 94.2 to resident beneficiaries and mutual funds that hold their interests in a non-resident trust directly. The general intent of section 94.2 is to ensure that a non-resident commercial trust cannot be utilized to circumvent the FAPI rules.

When conditions described in section 94.2 are met, the trust is deemed to be a foreign affiliate of the taxpayer. Where the non-resident commercial trust is deemed to be a foreign affiliate of the taxpayer, the trust will further be deemed to be a controlled foreign affiliate of the taxpayer. Consequently, the taxpayer will be required to include in computing its income a portion of the non-resident commercial trust’s FAPI, if any, as required by subsection 91(1).

The provision applies where the following conditions are met:

1. The trust is a non-resident commercial trust (more specifically, an “exempt foreign trust”) described in paragraph (h) or (i) of the “exempt foreign trust” definition in subsection 94(1) paragraph (a); and
2. Either:
   a. The total fair market value at that time of all “fixed interests” of a particular class in the trust held by the beneficiary, persons or partnerships not dealing at arm’s length with the beneficiary, or persons or partnerships that acquired their interests in the trust in exchange for consideration given to the trust by the beneficiary, is at least 10% of the total fair market value of all fixed interests of the particular class, or
b. The beneficiary or the particular person (i.e., of which the beneficiary is a controlled foreign affiliate) has contributed “restricted property” to the trust (restricted property generally includes common shares or similar property issued as part of an estate freeze)

3. The beneficiary is either: (i) a “resident beneficiary,” (ii) a “mutual fund,” (iii) a controlled foreign affiliate of the particular person, or (iv) a partnership of which a person described in any of subparagraphs (i) to (iii) is a member.

**Compliance requirements**

Investment funds and investors investing in non-resident investment structures should consider whether they need to comply with foreign reporting compliance requirements outlined below:

- **T1134** – for investments in controlled or non-controlled foreign affiliates
- **T1135** – for investments in specified foreign property exceeding $100,000
- **T1141** – for transfers or loans to non-resident trusts
- **T1142** – for distributions from and indebtedness to non-resident trusts

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172 Income Tax Act (Canada) Section 94
173 Views Doc No. 2013-0485311C6
174 CRA Views, Conference, 2013-0485311C6 – Offshore investment funds
175 Income Tax Act (Canada), Subparagraph 94.2(2)(a)(i)
176 Income Tax Act (Canada), Subsection 94(1)
177 Ibid, Subsection 94(1)
178 Ibid, commentary to 94(1)(b)
179 Ibid, Subsection 94(1)
180 Ibid, Paragraph 94(1)(c)
Other important topics
Flow-through shares

General rules

The flow-through share provisions are an exception to the basic scheme of the ITA providing that only the taxpayer that incurs an expense may deduct the expense. The concept of a flow-through share is that an investor enters into an agreement with a corporation that is carrying on a mining, oil and gas, renewable energy or energy conservation business to subscribe for shares of the corporation, and the corporation uses the subscription funds to incur qualifying exploration and development expenditures, which it then renounces to the investor.

Investor

When expenditures are renounced to the investor, the investor is deemed to have incurred the Canadian Exploration Expenditures (CEE) or Canadian Development Expenditures (CDE) renounced. The investor is then entitled to claim up to 30% (on a declining-balance basis) of the CDE and 100% of any CEE renounced. In most arm’s length situations, an investor will want only CEE, because of the rapid write-off available for these expenses in contrast to the comparatively slow write-off for CDE. Therefore, in most arm’s length agreements between corporations and investors, the corporation will warrant that it will incur CEE and renounce those expenses to the investor.

Corporation

The corporation can renounce only the qualifying expenses incurred during the period commencing on the day the agreement is entered into and ending 24 months after the end of the month that includes that day. Investors in public transactions will typically require that the corporation renounce the expenses for the year in which the investor subscribes for shares. The amount of CEE or CDE renounced to the investor is limited to the amount that the investor paid for the shares.

Where a corporation renounces CEE or CDE to an investor, the investor is deemed to have incurred those expenses and, except for the purposes of the renunciation, the corporation is deemed never to have incurred the expenses.

Dispositions of flow-through shares

The cost of a flow-through share to an investor is deemed to be nil regardless of whether the corporation has actually renounced the qualifying expenditures. In most circumstances, flow-through shares will be considered capital property to the investor. Accordingly, the investor will realize a capital gain on disposition equal to the full proceeds from the sale of the shares.
Mineral exploration tax credit

The Mineral Exploration Tax Credit is available to individuals who invest in mining flow-through shares. It is equal to 15% of specified mineral exploration expenses incurred in Canada and renounced by a corporation to flow-through share investors. Originally this tax credit was scheduled to expire on March 31, 2017 (see 2017 Budget updates).

Several provinces, including Ontario, Quebec, British Columbia, Saskatchewan, and Manitoba, offer similar credits to individuals with some offering certain enhanced or super credits in some instances.182

2017 Budget updates

1. The budget proposes to no longer permit eligible small oil and gas corporations to treat the first $1 million of CDE as CEE, for expenditures incurred after 2018 (including certain expenses incurred in 2019 that could be deemed to have been incurred in 2018 under the look-back rule). Previously an eligible small oil and gas corporation was permitted to re-characterize up to $1 million of CDE as CEE when renounced to shareholders under a flow-through share agreement. As noted above, CDE is deductible at a 30% rate on a declining balance basis while CEE is fully deductible in the year the expense is incurred.

   The proposal will not apply to expenses incurred after 2018 and before April 2019 that are renounced under a flow-through share agreement entered into after 2016 and before March 22, 2017.

2. The 2017 budget extended the 15% mineral exploration tax credit to flow-through share agreements entered into on or before March 31, 2018. This tax credit, which applies to flow-through share agreements entered into on or before March 31, 2018

3. The budget proposes to generally classify expenditures related to drilling or completing a discovery well as Canadian Development Expenses (CDE) (these expenses are currently treated as Canadian Exploration Expenses (CEE)). This proposal will also apply to expenditures incurred to build a temporary access road to, or in preparing a site in respect of, a discovery well. The budget states that drilling expenditures can continue to be classified as CEE, or reclassified as CEE, in situations where:
   - The well has been abandoned
   - The well has not produced within 24 months, or
   - The Minister of Natural Resources has certified that the relevant costs associated with drilling the well are expected to exceed $5 million and it will not produce within 24 months.

   In addition, CEE treatment will continue to be available for other expenses such as certain early stage surveying.

   Generally, a discovery well is an oil or gas well that results in the discovery of a previously unknown petroleum or natural gas reservoir. CDE is deductible at a 30% rate on a declining balance basis while CEE is fully deductible in the year the expense is incurred.

   This measure will apply to expenses incurred after 2018 (including certain expenses incurred in 2019 that could be deemed to have been incurred in 2018 under the look-back rule). The measure will not apply, however, to expenses actually incurred before 2021 where the taxpayer has entered into a written commitment before March 22, 2017 to incur those expenses.

181 ITA 66(12.6)
182 http://www.nrcan.gc.ca/mining-materials/taxation/8874
Accounting and tax differences

The Income Tax Act, Canada specifies the treatment of certain items that are different from their accounting treatment. Below are some common reconciling items between accounting income and taxable income.

Common book to tax reconciliation items

Management expenses
For accounting purposes, management expenses are recorded on an accrual basis based on the terms of the underlying management agreement. For income tax purposes, a deduction applies only to fees paid on account of capital. Fees chargeable against income are allowable as a deduction where they meet the usual criteria necessary for deduction in the computation of income from business or property, viz “made or incurred for the purpose of gaining or producing income from the business or property.” Where expenses are deducted by virtue of 20(1)(bb), such fees are generally tax deductible when paid. Expenses deducted outside of 20(1)(bb) should generally be deductible on an accrual basis presuming they are paid to earn income from a business or property under section 9(1) of the Act. Whether services provided by a person whose principal business is in respect of administration or management of shares or securities is a question of fact. However, the following services would normally qualify:

1. the custody of securities,
2. the maintenance of accounting records,
3. the collection and remittance of income, and
4. the right to buy and sell on their own judgement on behalf of some clients without reference to those clients.

Share/unit issuance and financing costs
For accounting purposes, such costs are generally either expensed as they occur, capitalized, or charged through equity. For tax purposes, these expenses are generally deductible on a straight-line basis over five years. Some examples of these costs are as follows:

An issuance or sale of

1. shares in the capital stock of a corporation by the corporation,
2. units in a unit trust by the unit trust,
3. interests in a partnership by the partnership, or
4. interests in a syndicate by the syndicate;
5. legal fees connected with the preparation and approval of a prospectus pertinent to the issuance or sale of shares, units, or interests;
6. accounting or auditing fees connected with the preparation of reports on financial statements and statistical data for inclusion in, or for presentation with, the prospectus;

7. the cost of printing the prospectus, new share, unit, or interest certificates, etc;

8. registrar or transfer agent’s fees; and

9. filing fees charged by any public regulatory body that requires the filing of a prospectus for acceptance.

Care should be taken when reviewing expenses classified as issuance or financing costs, as in some cases certain of these expenses may otherwise be current expense items or considered eligible capital property.

**Capital gain/losses**

There are many differences between accounting and tax purposes when it comes to the recognition and timing of income and losses from transactions in investments.

**Trade vs. settlement**

For accounting purposes, the disposition of securities occurs on the trade date, while for Canadian tax purposes, the disposition occurs on the settlement date.

**Accounting carrying value ("CV") vs. tax adjusted cost base ("ACB")**

The carrying value of a security for accounting purposes may differ from the tax ACB. For instance, securities are carried at FMV for accounting purposes. The tax ACB is generally at historical cost amounts. In addition, certain corporate actions may also be recorded at FMV and on a realized basis for accounting purposes, but can be recorded at cost or otherwise deferred for tax purposes. Commission and other transaction costs relating to securities can also create differences between the CV and ACB. For accounting purposes these fees are expensed, while for tax purposes these fees are required to be capitalized.

**Suspended losses**

In the case of losses incurred for accounting purposes on certain properties held by a taxpayer and to the extent they are of an income or capital nature, such losses may be denied in the computation of taxable income. The details of these rules are explained in the section on Suspended Losses.

**Dividend income and expense**

For accounting purposes, dividend income earned by an investor is typically recognized on an accrual basis, whereas for income tax purposes, the Act includes such income generally when received by the taxpayer.

For comments on dividend compensation expense payments made when securities are sold short by an investment fund, please refer to the section on Securities Lending Arrangements.

**Foreign withholding taxes ("WHT")**

For accounting purposes, WHT is generally recorded either as a reduction of dividend income or a separate expense item with the statement of income. For tax purposes, depending on the nature of the income received, WHT may be regarded as a foreign tax credit ("FTC") utilizable against taxes payable or as a deduction in the determination of taxable income or loss. Certain limitations regarding the amount and extent to which a taxpayer may choose between utilization of the FTC or deduction of such foreign taxes paid may arise in instances where the foreign taxes are subject to a reclaim, or when the taxpayer receives the FTC from an allocation from an underlying investment fund. Notwithstanding any limitations under the Act, WHT claimed by a taxpayer as FTC is generally more advantageous than taking a deduction. For further details and discussion, see the section on Foreign Withholding Taxes.

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183 Income Tax Act (Canada) Paragraph 20(1)(bb)
184 Ibid, Subsection 9(1)
GST/HST and QST on investment funds

The Goods and Services Tax and the Harmonized Sales Tax ("GST/HST") and the Quebec Sales Tax ("QST") rules for investment funds are complex, both in terms of structuring and ongoing compliance. As an added challenge, the federal government is proposing to change the GST/HST treatment of investment partnerships.

This chapter provides an overview of some of the key structuring and compliance considerations for funds that qualify as an "investment plan" under the GST/HST and QST rules, and discusses some of the proposed changes and consultations announced on July 22, 2016 by the Department of Finance ("Finance").

In general, the definition "investment plan" under the GST/HST rules includes various types of investment entities such as, mutual fund trusts, unit trusts, investment corporations and mutual fund corporations. Other GST/HST rules apply for other types of investment structures. In this chapter, the terms "investment plans," "investment funds" and "funds" are used interchangeably.

**General tax framework**

In general, the 5% GST applies across Canada. The HST applies in Ontario at a rate of 13%, and at a rate of 15% in New Brunswick, Nova Scotia, Prince Edward Island, and Newfoundland and Labrador. The HST is essentially a combination of the 5% federal GST and a provincial component of 8% or 10% based on the particular HST-participating province. In addition to the GST, the province of Quebec also levies a value added tax, the QST applicable at 9.975%, which has rules similar to the GST/HST rules. The provinces of British Columbia, Saskatchewan and Manitoba each have their own provincial sales tax, also known as retail sales tax, that applies at a rate of 6% to 8% based on the particular province. Higher PST rates apply to certain transactions. The PST rules are significantly different from the GST/HST and QST rules. The province of Alberta does not levy a provincial sales tax.

For the purposes of this chapter, reference will only be made to the GST/HST rules, unless otherwise noted.

In general, the *Excise Tax Act* (the "ETA") treats investment plans as "persons," notwithstanding that they may not be persons at law (e.g., partnerships or trusts). This means that investment funds are capable of making or receiving supplies that may be subject to GST/HST. This also means that the structuring of investment plans requires an analysis of every payment stream between every entity in the structure to determine whether GST/HST applies, and to determine the extent to which these taxes may be recoverable.
The GST/HST applies to the consideration (e.g., payment) paid for taxable supplies made in Canada. On that note, and despite common misconceptions, payments can change character for GST/HST purposes as they are made between different entities. Interest received by an investment plan, for example, is not necessarily treated as interest when a portion of it is paid by the plan to an asset manager; in other words, the fact that a payment to an asset manager is computed by reference to interest, dividends or other revenues of the investment plan does not necessarily make that payment interest or dividend for purposes of GST/HST.

In general, a person registered for GST/HST purposes can recover the GST/HST paid on its expenditures by claiming input tax credits (ITCs) to the extent that the expenditures are incurred in the course of its commercial activities. A commercial activity generally includes making taxable supplies subject to GST/HST (including zero-rated supplies). However, a commercial activity does not include making exempt supplies. While GST/HST does not apply on exempt supplies, suppliers cannot claim any ITC related to the GST/HST they incur in making those exempt supplies.

Most of the operating expenses acquired by investment plans are treated as taxable supplies for GST/HST purposes. However, certain supplies that could otherwise be tax-exempt when received by someone else, may be taxable when received by an investment plan, such as brokerage (because of paragraph (q) of the definition of “financial service” in subsection 123(1) of the ETA).

Special rules for investment plans

Because of the foregoing GST/HST framework, investment plans would have generally perceived an incentive to relocate to provinces with lower GST/HST rates, like Alberta, to reduce the amount of unrecoverable GST/HST incurred on their inputs.

To counter that, GST/HST rules were introduced effective July 1, 2010 to make certain “investment plans” as defined in subsection 149(5) of the ETA “selected listed financial institutions” (“SLFIs”) for purposes of GST/HST. The GST regime was amended to substantially adopt these same rules effective as of January 1, 2013. As such, investment plans structured as mutual fund trusts, unit trusts or mutual fund corporations, among other entities, for purposes of the Income Tax Act (Canada) that have investors in several provinces are generally considered SLFIs for purposes of the ETA.

What this means in simple terms is that while a SLFI investment plan pays GST/HST to its suppliers with respect of taxable supplies, the SLFI investment plan's net GST/HST cost may not be the same as the amount of GST/HST paid to its suppliers.

On a day-to-day basis, investment plans usually pay GST/HST based on the location of their trustees, in accordance with the place-of-supply rules. For example, a fund with a trustee resident in Ontario would generally be charged HST at 13% by most of its suppliers.

However, each SLFI investment plan must calculate its net tax cost on its SLFI return by using the special attribution method (“SAM”) calculations. Most investment plans have annual reporting periods and file this return on an annual basis. A SLFI investment plan’s overall GST/HST cost is calculated by reference to the proportion of its net asset value held for investors that reside in each province, a calculation also known as the provincial attribution percentages.

To determine their provincial attribution percentages for each province, some SLFI investment plans must use special look-through rules related to certain investors, which may include other investment plan investors. The ETA includes complex information sharing rules between some investors and investment plans to help ensure that the investment plans can comply with the look-through rules and calculate the proper percentages of investors in each province. Based on the information sharing rules, investment plans must, among other requirements, request specific information from certain investors. Notwithstanding this obligation of investment plans, certain investors are required to provide specific details no later than November 15 even if they do not receive a written request from the investment plans.

If the investment plans have investors that reside outside of Canada, the plans are required to include these investors in their calculations as residents in Canada but not resident in any HST-participating province, and thus limiting the related tax cost to 5% GST. However, an investment plan may make an election that will allow the plan to exclude non-resident investors from its provincial attribution percentage calculations. While the election may allow the qualifying investment plans to potentially claim some eligible ITCs, it may affect their overall provincial attribution percentages and tax costs. The effects of the elections must be carefully reviewed.
In general, the SAM calculations compute an adjustment related to the provincial component of the HST that is based on the GST and the federal component of the HST incurred in the reporting period and on the provincial attribution percentages for each HST-participating province. The provincial component of the HST incurred during the particular reporting period is then deducted from the adjustment. The net adjustment is then reported on the SLFI return. Similar rules apply for QST purposes.

The filing of the SLFI return can give rise to a refund if the tax paid throughout the reporting period (e.g., annual) on the plan's inputs (e.g., asset management fees, custodial fees, audit fees) was at a rate higher than the amount of tax calculated on the SLFI return of the fund for that reporting period. It can also give rise to tax payable if the opposite is true. For example, a SLFI investment fund based in Alberta with almost all of its investors in Ontario would pay tax at 13% on all its taxable inputs. Conversely, an investment plan in Ontario with almost all of its investors in Alberta would essentially pay tax at 5% on all of its taxable inputs. Plans with investors across Canada end up paying tax at a rate somewhere between 5% and 15%.

The rate for a particular year is generated by the provincial attribution percentages of the investment plan at one or more points in time in the previous year (usually September 30), although the ETA contemplates a plethora of alternative methods, including eye-wateringly complex rules governing the selection of an attribution date (including eye-wateringly complex rules governing the selection of an attribution date for new or merged plans and series.

The SAM calculations are essentially done at the level of each series of an investment plan. A SLFI investment plan is then required to calculate the GST/HST adjustments of all its series and report the net payable or receivable amount on its GST/HST SLFI return.

To ease compliance and cash-flow concerns for SLFI investment plans, the ETA provides three optional elections:

1. A “reporting entity” election that allows the manager to file returns on behalf of a SLFI investment plan;
2. A “consolidating filing” election that allows the filing of a single (albeit complex) return for multiple SLFI investment plans; and
3. A “tax adjustment transfer” election, or “TATE”, that allows the manager to effectively charge GST/HST at the SLFI investment plan’s blended rate on its supplies to the plan. Although this is the colloquial understanding of the mechanism, the manager continues to charge and collect GST/HST at the statutory rate imposed under the place-of-supply rules, and the plan effectively “transfers” its potential SLFI refund to the manager, so that the manager can remit the tax collected net of the refund to the tax authorities.

Similar elections are available for QST purposes.

However, suppliers who are not the manager of an investment plan cannot avail themselves of the TATE election and are required to charge GST/HST (and QST, if applicable) to the investment plan (or legally, to the plan trustee). Some investment plans with a TATE election can transfer to their managers the refund or liability related to GST/HST paid on supplies from third-party vendors. However, where investment plans with a TATE election are not entitled to transfer the refund or liability related to third party vendors, the investment plans may face cash-flow issues insofar as they end up with tax payable or a refund of GST/HST paid upon filing their SLFI returns.

**Cross-border issues and structuring**

Absent of special self-assessment rules for purchases made outside Canada, investment plans would have an incentive to acquire their taxable supplies outside Canada or relocate outside Canada altogether to save GST/HST (and QST) on their taxable inputs (subject to securities regulations concerns).

As financial institutions, investment plans are generally subject to two concurrent self-assessment regimes in the ETA. Under the first set of rules in section 218 of the ETA, an investment plan based in Canada is generally required to self-assess GST/HST on “imported taxable supplies” imported from non-resident vendors. An imported taxable supply can include asset management fees, custodial fees, audit fees and loan servicing fees. If the investment plan is a SLFI, the plan is required to self-assess the 5% and determine, under the SAM calculations, the tax adjustment related to the provincial component of the HST or the QST.

A second set of special rules for financial institutions, including investment plans, may apply when the self-assessment rules in section 218 do not apply. These rules are intended to capture certain services supplied to Canadian financial institutions from non-resident head offices, affiliates or branches. This second set of rules are extremely broad and can even apply to payments that would be otherwise GST/HST exempt when made domestically, such as payments for certain types of financial services.
There are also challenges in structuring investment plans so they can reside outside of Canada. While investment plans outside Canada may not be subject to GST/HST self-assessment requirements (subject to the caveats below), the ETA contains specific rules governing the residence of entities most often chosen in structuring investment plans – these rules may not be the same as the income tax rules.

Moreover, some non-resident trusts can be deemed resident in Canada for purposes of the self-assessment rules if they hold $10 million or more in assets for the benefit of Canadian resident beneficiaries, representing 10% or more of the total value of their assets. Such non-resident trusts could accordingly be required to self-assess GST/HST on the proportion of their inputs related to the resident investors if they meet all the criteria of these complex rules.

Whether or not a particular investment fund is resident in Canada for GST/HST (and QST) purposes would not only affect the fund’s obligation to self-assess tax, but would also be relevant in determining whether various suppliers, including the manager, are required to charge tax on their various supplies to the fund. Taxable supplies made to non-residents can be zero-rated, so the supplier does not charge tax on the supply but can still claim ITCs, but only where certain conditions are met. One such condition is that the recipient of the supply (here, the fund), be non-resident of Canada for GST/HST purposes.

**Tips and traps**

In our experience, some of the most common GST/HST and QST challenges for investment plans and their managers include:

a. **New investment plans** – For each new investment plan or series, the proper attribution date must be selected and the provincial investor attribution percentages and any related adjustments must be calculated.

b. **Expense accruals and reconciliation of tax costs** – The manager’s fees and tax thereon are usually accrued daily by the investment plans and some of the amounts accrued at the end of one fiscal year may not become payable or paid until the following fiscal year. This can lead to reconciliation issues.

c. **Remittance of QST to the wrong tax authority (TATE elections)** – The CRA manages GST/HST and QST for all SLFI investment plans, but very few asset managers are SLFIs. As a result, when a TATE election is in place, amounts collected by the asset manager from each investment plan on account of QST must be remitted to Revenue Québec, not the CRA (there is a separate remittance form for asset managers that are not QST registrants).

d. **Identifying the recipient of the supply** – In some cases, it may be necessary to review the agreements and the nature of expenses to determine the recipient of the supply. This is particularly important if the recipient may be entitled to recover all or part of the GST/HST paid.

e. **Look-through rules** – The ETA contains complex look-through rules that SLFI investment plans must apply to determine their provincial attribution percentages. Similarly, they may be required to give their own provincial attribution percentage to the SLFI investment plans in which they invest (subject to penalties for non-compliance). These rules are often misapplied.

f. **Missed ITCs** – Some investment plans may have commercial activities insofar as they make investments that qualify as zero-rated for purposes of section 1 of Part IX of Schedule VI of the ETA.

**The July 22, 2016 proposed amendments and consultations**

On July 22, 2016, the Federal Department of Finance introduced comprehensive proposed amendments to the ETA, including many that could have a significant impact on the investment plan industry. The proposals introduce, among other changes, long-anticipated rules that essentially bring master trusts of pension entities within the application of the GST/HST pension plan rules.

Finance’s draft legislation also proposes changes to:

a. Extend the SLFI rules to group trusts for registered education saving plans;

b. Amend some provisions related to qualifying small investment plans in light of the changes related to master trusts;

c. Clarify the amounts to be included in the SAM formula related to the section 150 closely related group election; and

d. Simplify the SAM formula to reflect the fact that it is common for SLFIs to make a certain election under the SAM formula.

Finance has not released any additional related information since the release of the original proposals.
At the same time, Finance also released a 16-page consultation paper concerning the GST/HST rules for certain limited partnerships and investment plans. The paper includes the following proposals but does not propose effective dates for the measures.

**Expand SLFI rules to include investment limited partnerships**

In the consultation paper, Finance proposes to expand the SLFI rules to include investment limited partnerships. Finance notes that the proposed changes would address the “uneven treatment between investment entities structured as limited partnerships and entities that are currently defined as investment plans.”

In the paper, Finance discusses many aspects of how the SLFI rules may apply to investment limited partnerships, including determining the permanent establishments of a partnership as well as the calculation of the provincial attribution percentages for GST/HST.

**Changes to the definition of investment plan**

The paper proposes to include “investment limited partnership” in the definition of “investment plan” for GST/HST purposes. As an investment plan and listed financial institution, an investment limited partnership could be subject to the SLFI rules if the partnership qualifies as a SLFI, as well as being subject to all the other rules that affect financial institutions.

Finance proposes to define the term “investment limited partnership” to “include a limited partnership whose principle activity is the investing of funds on behalf of a group of investors through the acquisition and disposition of financial instruments.”

**Permanent establishment test**

The consultation paper proposes that an investment limited partnership would generally be considered a SLFI if it has a permanent establishment in an HST-participating province and a permanent establishment in any other province. An investment limited partnership would generally “be deemed to have a permanent establishment in a province if a partner holding one or more of its units (i.e., an interest in the partnership) is resident in the province or if the investment limited partnership is able to sell or distribute its units in the province.” The SLFI rules have criteria for different types of persons to help determine whether a particular person is resident in a particular province.

The paper also proposes to provide special rules to determine SLFI status similar to the ones for certain investment plans that have two or more provincial series, or whose units are designed to be sold or distributed to investors in a single province.

**Provincial attribution percentages**

To determine the provincial attribution percentages of investment limited partnerships that qualify as SLFIs, Finance proposes in the consultation paper to use rules similar to the current rules that apply to distributed investment plans. The calculations would generally be based on the value of units held by partners that reside in the province.

The consultation paper notes several components of the current SLFI rules that Finance is considering, or for which Finance was specifically seeking feedback for investment limited partnerships, including:

- a. The three methods to determine and apply the provincial attribution percentages (i.e., preceding-year, current year and real-time methods)
- b. The provincial attribution percentage rules for investment plans with more than one series of units
- c. The look-through rules (i.e., the information sharing requirement rules)
- d. The attribution of unit holder rules under which investment plans may be required, in determining their provincial attribution percentages, to allocate the value of the units to the HST-participating province with the highest provincial tax rate when certain investor information is missing.

**Expand the self-assessment rules**

The consultation paper proposes to amend the imported supplies rules for financial institutions to ensure that certain non-resident limited partnerships would be required to self-assess an amount of GST/HST in respect of their Canadian activities.

**New GST rebate**

The paper proposes to introduce a new GST rebate for certain investment plans that have non-resident investors.

Finance has not released any additional related information since the release of the original consultation.
Common reporting standard

Canada’s government passed legislation in 2016 to implement the Organisation for Economic Cooperation and Development (“OECD”) Common Reporting Standard (“CRS”). Sections 270 to 280 of Part XIX of the Income Tax Act, Canada (“the Act”) were introduced which came into force on July 1, 2017.

Under CRS, the Canada Revenue Agency (“CRA”) will provide foreign tax authorities with information on financial accounts in Canada held by residents of their jurisdiction. In turn, foreign tax authorities will provide the CRA with corresponding information on financial accounts in their jurisdictions held by Canadian residents. Canadian financial institutions required to report under Part XIX of the Act must have procedures in place by July 1, 2017 to identify financial accounts held by tax residents of various foreign jurisdictions and report prescribed information pertaining to these accounts to the CRA beginning in 2018. A wide variety of entities including certain asset managers and investment entities are considered financial institutions for the purposes of CRS.

As of June 2017, more than 100 jurisdictions have committed to implement CRS. While the intention is to have a single global information-sharing standard, requirements will vary across countries, making it more challenging for financial institutions to standardize their approach. CRS for many financial instructions has meant, similar to U.S. Foreign Account Tax Compliance Act (“FATCA”), changes to the operational and system requirements around onboarding and maintenance of client account information. KPMG’s guiding principles for CRS design considerations are as follows:

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<td>- Enterprise deployment procedures</td>
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What are we solving for? + What to do (and not)? = Good system design
The CRA has issued guidance in 2017 that clarifies many aspects of the CRS legislation. The CRA states in the guidance that in the event of any variation between the OECD Commentaries on the CRS, the OECD FAQ and guidance, the guidance prevails as the CRA’s view.

The following highlights certain considerations from the guidance that are of importance for asset managers.

**Application to asset management industry**

The CRA guidance provides clarity in certain areas and addresses many of the concerns raised by a number of industry groups. Specifically, the guidance extends relief for client name accounts held by investment funds and dealers to client name accounts held by custodians and investment managers. Further, the guidance sets parameters under which financial institutions can rely on documentation collected by their agents to reduce their own documentation procedures, and reduce the number of controlling persons that must be reported for collective investment vehicles established as trusts in countries that are not participating jurisdictions for CRS purposes. However, some additional clarification would be welcome in certain areas, including how broadly to interpret certain comments made regarding using some FATCA and CRS definitions interchangeably.

The guidance also notes that, unlike FATCA, CRS does not contain the concepts of exempt beneficial owners and deemed-compliant financial institutions. In addition, the CRS rules do not provide an exemption for financial institutions with a local client base. As a result, certain asset managers that relied on these exemptions for FATCA purposes will not be exempt from CRS.

For funds that are organized as a partnership, if control and management of the partnership’s activities takes place in Canada, the partnership is considered resident in Canada for CRS purposes pursuant to the guidance. This is helpful, as partnerships are generally not considered “entities” that have a residence status and, without guidance, different practices could have been applied.

The CRA guidance further clarifies that an entity will not be classified as a financial institution under CRS solely because it carries on a business of providing customers with non-binding investment advice that does not involve any form of portfolio management or investing, administering or managing of financial assets or money on behalf of other persons.

**Compliance requirements**

Canadian financial institutions are required to have procedures in place as of July 1, 2017 to carry out the required documentation, due diligence and reporting pursuant to Part XIX of the Act. In particular, Canadian financial institutions are required to collect appropriate self-certifications and documentary evidence from their customers and, in certain instances, holders of their debt and equity, in order to identify reportable accounts and to validate and store the documentation obtained. They are also required to keep records for six years after the end of the last calendar year in which the record is relevant, or in the case of self-certifications, six years after the date on which the financial account is closed.

By May 1 of each year, Canadian financial institutions with reportable accounts are required to electronically file *Part XIX Information Return*. The first annual CRS reporting to the CRA is due on May 1, 2018 for accounts maintained during 2017. Canadian financial institutions are allowed to have third party service providers to fulfill their reporting and due diligence obligations on their behalf.
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