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TaxNewsFlash

Canada

2021 Federal Budget — Focus on Asset Management

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The asset management industry may be affected by certain new tax measures in the 2021 federal budget. The budget, which was presented on April 19, 2021, introduces several important changes that asset management entities should be aware of, including:

- Taxes on registered investments
- Allocation-to-redeemers methodology for mutual funds
- Fixing contribution errors in defined contribution pension plans
- Electronic filing and certification of tax and information returns
- Rate reduction for zero-emission technology manufacturers
- Mandatory disclosure rules
- Interest deductibility limits
- Hybrid mismatch arrangements
- Green bonds
- Flow-through shares.

Taxes on registered investments

The budget proposes to provide relief from the penalty tax payable by certain registered investments to the extent that their shares or units are not held by investors subject to qualified investment rules. In particular, the budget proposes prorating the penalty tax under subsection 204.6(1) for certain trusts and corporations based on the proportion of the units of the trust or shares of the corporation held at the end of the applicable month by RRSPs, DPSPs, RRIFs and other registered investments under paragraphs 204.4(2)(b), (d) or (f). This proposal would apply to:

- Quasi-pooled fund trusts (under paragraph 204.4(2)(b))
- Quasi-mutual fund trusts (under paragraph 204.4(2)(d)), and
- Quasi-mutual fund corporations (under paragraph 204.4(2)(f)).

The budget proposes that this measure apply in respect of months after 2020, and also in respect of months before 2021 for taxpayers whose penalty tax liability has not been finally determined by the CRA as of April 19, 2021.

KPMG observations
This proposed measure provides welcome relief for registered investments that have a significant proportion of units or shares that are not held by investors subject to qualified investment rules. For example, this change would provide relief to a bottom fund that is a quasi-mutual fund trust, of which a significant proportion of units are held by top funds that are mutual fund trusts.

Because the budget proposes that the proration be based on the number of units or shares, it does not appear to take into account that a fund may issues units or shares in different classes or series with different net asset values. Also, it does not appear that the proposal takes into account that units or shares of registered investments may be held by TFSAs, RESPs or RDSPs subject to qualified investment rules.

The investment industry continues to have discussions with Finance to broaden the list of what constitutes a qualified investment or provide for a carve-out for pooled funds from the investment restrictions which are proposed under the existing tax rules similar to that of investment funds which have mutual fund status.

Allocation-to-redeemers methodology for mutual funds

The budget confirms that the government intends to proceed with the mutual fund allocation-to-redeemer proposals released on July 30, 2019. These proposals apply to trusts that are “mutual fund trusts”. Generally, the proposals will prohibit the allocation of ordinary income to redeemers, and limit the allocation of capital gains to the capital gains that the redeemers would realize, but for the allocation. The July 2019 proposals modified rules originally proposed in the March 2019 budget that included some relief for the calculation of the capital gain that a redeemer would realize but for the allocation. In particular, the previous proposalsstate that the trustee must determine the cost amount of the units using reasonable efforts.

KPMG observations
The budget does not address Finance and industry consultations on a potential deferral to alleviate the negative effects that the proposals have on exchange traded funds (ETFs) regarding the allocation of capital gains. This potential relief, which was not mentioned in the budget, would defer application of the proposed legislation on ETFs, given the expiry of a previous deferral of the rules which was to apply to ETFs that had a taxation year that begins after March 20, 2020. Finance has said that it intends to soon issue a comfort letter on the extended deferral.

Fixing contribution errors in defined contribution pension plans

The budget proposes to simplify the reporting requirements necessary to fix contribution errors to defined contribution pension plans and provide additional flexibility to plan administrators. The plan administrator will be required to file a prescribed form in respect of each affected employee rather than amend T4 slips for prior years. Additional contributions to correct for under-contributions would reduce the employee’s registered retirement savings plan (RRSP) contribution room for the taxation year following the year in which the retroactive contribution is made.

For under-contribution errors, additional contributions can be made to correct the under-contribution. This will affect the employee’s contribution room in the taxation year following the year in which the retroactive contribution is made. For over-contribution errors, a refund of the overcontribution to the contributor (employer or employee) will restore the employee’s RRSP contribution room for the taxation year in which the refund is made.

Adjustments are generally available to correct errors in any of the previous five years, subject to a dollar limit. This measure applies for 2021 and subsequent taxation years.

KPMG observations
This proposed adjustment is welcome as it greatly simplifies the process to fix contribution errors to defined contribution pension plans, and enables plan administrators to correct for both under-contributions and over-contributions.

Upcoming trust beneficiary disclosure requirements

Many Canadian trusts will soon have to face new enhanced reporting requirements. As part of these requirements, trusts will be required to obtain detailed information and meet new obligations, effective for tax years ending after December 30, 2021 (i.e. effectively the rules apply to a trust’s tax year ending on December 31, 2021 and subsequent). These new rules may be onerous for certain trusts. For example, an affected trust will have to provide information pertaining to a trust's beneficiaries, trustees, settlors and even protectors on its income tax return. Trusts that fail to report required information may face significant penalties of up to 5% of the highest total fair market value of all property held within the trust during the year. Note that mutual fund trusts and segregated funds are expect to be exempted from these new requirements.

For details, see *TaxNewsFlash-Canada* 2020-81, "Prepare for Upcoming Trust Reporting Rules".

Electronic filing and certification of tax and information returns

The budget proposes amendments to various electronic filing, electronic correspondence and electronic payment requirements, which are intended to improve the CRA's ability to operate digitally.

Among other notable changes, these proposals:

- Make electronic correspondence the CRA's default correspondence method with businesses that use the CRA's My Business Account portal (taxpayers can still elect to receive paper copies), effective on Royal Assent
- Allow issuers of T4A and T5 information returns to provide the returns to taxpayers electronically without requiring taxpayer authorization, effective for information returns sent after 2021
- Require filers of information returns with more than five information slips to file electronically (reduced from 50 previously), effective for calendar years after 2021, and
- No longer require handwritten signatures on forms T183, T183CORP, T2200, RC71, and RC72, effective on Royal Assent.

KPMG observations
The proposed amendments provide greater access to electronic filing and correspondence that may simplify reporting obligations and tracking notifications, and will eliminate the need for "wet-ink" signatures on certain filings. In particular, issuers of T4A and T5 information returns are able to provide returns to taxpayer electronically without having to issue a paper copy and without needing authorization from the taxpayer.

Rate reduction for zero-emission technology manufacturers

The budget temporarily reduces the small business tax rate to 4.5% (from 9%) and the general corporate tax rate to 7.5% (from 15%) on eligible zero-emission technology manufacturing and processing income.

In order to qualify, at least 10% of the taxpayer's gross revenue from all active business income carried on in Canada must be derived from eligible activities. The income eligible for the reduced rate would be equal to the taxpayer's "adjusted business income", multiplied by the proportion of labour and capital costs that are used in eligible activities. Examples of eligible activities include, among others:

- Manufacturing of solar, wind, and water energy conversion equipment
- Manufacturing of geothermal energy equipment
- Manufacturing of electrical energy storage equipment used for storage of renewable energy
- Manufacturing of zero-emission vehicles (and batteries, fuel cells, and charging systems for zero-emission vehicles)
- Production of hydrogen for electrolysis of water, and
- Production of solid, liquid or gaseous fuels from carbon dioxide or specified waste material.

The budget did not propose any corresponding changes to the dividend tax credit rates and gross-up factors in connection with the rate reduction.

The reduced rates would apply to taxation years that begin after 2021. The reduced rates would be gradually phased out beginning in 2029 and fully phased out after 2031.

KPMG observations
This proposal may be of particular interest to manufacturers looking to attract financing or capital investment for their business and operations, given the enhanced after-tax cash flow that these tax incentives may provide.

Mandatory disclosure rules

The budget proposes mandatory disclosure rules in order to expand the existing reportable transaction rules. These rules include new requirements to report notifiable transactions and for certain corporations to report uncertain tax treatments.

These proposals expand the reportable transaction rules to only require one generic hallmark (instead of the current rules which require two of three generic hallmarks) to be present for a transaction to be reportable. In addition, for purposes of the rules, the definition of avoidance transaction would be amended so that a transaction would be considered an avoidance transaction if it can reasonably be concluded that one of the main purposes of entering into the transaction is to obtain a tax benefit. Finally, a "dual reporting" approach would be adopted whereby both the taxpayer and the promoter would be required to report "avoidance transactions" within the same specified time limits.

The proposals also introduce new notifiable transaction rules that would allow the Minister of National Revenue, with the concurrence of the Minster of Finance, to designate certain transactions as "notifiable transactions". The description of a notifiable transaction would set out the fact patterns or outcomes in sufficient detail to enable taxpayers to comply with the disclosure rule. These rules would also include examples in appropriate circumstances. Notifiable transactions would have to be reported by both the taxpayer and promoters or advisors within specified time limits to the CRA.

Finally, the proposals introduce reporting obligations in respect of uncertain tax treatments. A corporation would be required to report an uncertain tax treatment to the CRA where:

- The corporation is required to file a Canadian tax return
- The corporation's assets exceed $50 million
- The corporation or a related corporation has audited financial statements prepared under IFRS or other country-specific GAAP, and
- The corporation's income tax uncertainty is reflected in those audited financial statements.

Taxpayers would generally be subject to penalties for failures to report, and the normal reassessment period would not commence in respect of a transaction until the taxpayer has complied with the reporting requirement.

The proposed amendments are intended to apply to transactions entered into on or after January 1, 2022. Finance is expected to issue the draft legislation soon and will accept comments on the proposed rules before September 3, 2021.

KPMG observations
These proposed rules would expand the number of transactions subject to reporting and provide the CRA additional time to review such transactions before they become statute-barred. Finance expects to release sample notifiable transactions in the coming weeks that should provide greater insight into the types of transactions targeted by the rules (currently, the budget only references certain straddle-period planning transactions). The rules may apply to public companies that meet the asset threshold as well as private companies if they meet the asset threshold and have audited financial statements that report in accordance with IFRS or other country specific GAAP. The proposed rules currently leave open a number of questions regarding both the inclusions and the measurement framework that would apply, given the various options permitted under the accounting rules regarding uncertain tax positions.

International tax measures

Interest deductibility limits

The budget introduces an earnings-stripping rule to limit the net interest expense deduction to no more than a fixed ratio of 30% (40% in the first year of application) of "tax EBITDA" (i.e., earnings before interest, taxes, depreciation and amortization).

These limits are intended to apply in circumstances where excessive debt or interest deductions are created through, for example:

- Interest payments to related non-residents in low-tax jurisdictions
- The use of debt to finance investments that earn non-taxable income, or
- Having Canadian businesses bear a disproportionate burden of a multinational group's third-party borrowings.

Tax EBITDA refers to the corporation's taxable income before interest expense and interest income (including amounts economically equivalent to interest and other financing-related expenses and income), income tax, and deduction for depreciation and amortization for tax purposes. Income would exclude, among other things, dividends to the extent they qualify for the inter-corporate dividend deduction on amounts received from foreign affiliates. The interest expense excludes denied interest expense under the thin capitalization rule and interest between Canadian members of a corporate group.

The new rule applies to corporations, trusts, partnerships, and Canadian branches of non-resident taxpayers. The existing thin capitalization rule will continue to apply in conjunction with the new rule.

The budget notes that taxpayers may be able to carry back denied interest up to three years and forward up to 20 years, and that Canadian members of a group may be able to transfer the unused capacity to deduct interest to other Canadian members of the group. However, banks and life insurance companies may not transfer unused capacity to other members that are not regulated banking or insurance entities, subject to further consideration and comments from stakeholders.

The budget provides limited exemptions from the rule for the following taxpayers:

- CCPCs that have taxable capital employed in Canada of less than $15 million (together with any associated corporations), and
- Groups of corporations and trusts whose aggregate net interest expense among their Canadian members is $250,000 or less.

The budget also includes a "group ratio" rule to allow a taxpayer to deduct interest in excess of the fixed ratio of tax EBITDA where the taxpayer can demonstrate that the ratio of net third-party interest to book EBIDTA of the consolidated group implies a higher deduction limit would be appropriate. Adjustments would be made for entities with negative book EBIDTA.

The rule will apply to taxation years beginning on or after January 1, 2023 for which the limit will be 40% of tax EBITDA, and for taxation years beginning on or after January 1, 2024, for which the limit will be 30% of tax EBITDA. Finance intends to release further details in the summer of 2021 for comment.

Hybrid mismatch arrangements

The budget introduces hybrid mismatch arrangement rules by implementing the OECD's BEPS Action 2 recommendations, as adapted for the Canadian income tax context. Hybrid mismatch arrangements are generally cross-border arrangements that result in mismatches in the tax treatment of payments across different countries due to differences in the income tax treatment of hybrid entities or hybrid instruments.

The budget refers to the following forms of hybrid arrangements addressed by the BEPS Action 2 recommendations:

- Deduction/non-inclusion mismatches where payments are deductible in one country without corresponding inclusion within a reasonable time in ordinary income (i.e., income subject to income tax at the recipient's full tax rate without exemption, exclusion, deduction, credit or similar tax relief) in the other country
- Double deduction mismatches where the same expense is deductible in two or more countries
- Imported mismatches where a payment deductible in one country is included in the recipient's income in a second country, but that income is offset by a deduction under a hybrid mismatch arrangement between the recipient and an entity resident in a third country
- Branch mismatch arrangements.

The budget provides an outline of the main proposed rules:

- Canadian resident payors will not be permitted to deduct payments made under hybrid mismatch arrangements to the extent the payments are deductible in another country or are not included in the ordinary income of a non-resident recipient
- Payments made by a non-resident under hybrid mismatch arrangements that are deductible in a foreign country will not also be deductible by a Canadian resident and, if the payments are received by a Canadian resident, the payments must be included in the Canadian resident's income without any offsetting deduction for certain dividends received from foreign affiliates.

The budget notes that the rules will not include a purpose test, but that they will be mechanical in nature. To ensure coordination with similar rules in other countries, there will also be ordering rules consistent with the Action 2 recommendations. Further, the rules will generally apply to payments between related parties and payments under certain arrangements between unrelated parties designed to produce a mismatch.

The government proposes to implement the rules in two separate legislative packages. The first package, intended to neutralize deduction/non-inclusion mismatches resulting from payments in respect of financial instruments, will be released for comment later in 2021, and will apply as of July 1, 2022. The second package, containing the remaining Action 2 recommendations, will be released for comment after 2021 and would apply no earlier than 2023.

KPMG observations
The budget's proposed interest deductibility and hybrid mismatch rules are generally consistent with the OECD's BEPS Action Plans. By introducing these rules, Canada will join several other countries that have already introduced similar rules. The current rules do not contain a carve-out for collective investment vehicles (CIVs) particularly those that are in the alternative investment category.

Asset managers, particularly in the private equity, private credit and infrastructure contexts, should monitor the release of the interest deductibility and hybrid mismatch proposals and consider the impact to their particular cross-border investment structures.

Green bonds

The budget proposes that the government publish a green bond framework, in advance of issuing its first federal green bond in 2021-22. Finance will co-lead the development of the framework with Environment and Climate Change Canada, in conjunction with other departments and Crown corporations. Canada's green bonds could fund projects such as green infrastructure, clean tech innovations, nature conservation, and other efforts to address climate change and protect the environment.

KPMG observations
By creating a green bond framework and issuing green bonds, Canada will be able to participate in the rapidly growing market for investments aligned with environmental values.

Flow-through shares

The budget confirms the government's intention to proceed with previous proposals to extend the timelines for eligible flow-through shares by 12 months. Certain junior mining exploration companies and other junior resource corporations are permitted to issue flow-through shares to investors that enable the company to renounce certain resource expenses such that the holders of the flow-through shares can instead claim those expenses. Currently, in order to qualify, the expenses must be incurred in the period that begins on the day on which the relevant flow-through share agreement is entered into and ends 24 months after the end of the month that includes that day.

These legislative proposals, which were released on December 16, 2020, apply to flow-through share agreements entered into on or after March 1, 2018 and before 2021.

KPMG observations
The budget reaffirms the previous proposals that flow-through share arrangements entered into between March 1, 2018 and before 2021 should benefit from the 12-month extension. However, the budget does not indicate that the extension will apply to any arrangements entered in 2021 or later.

We can help

Your KPMG adviser can help you assess the effect of the tax changes in this year's federal budget on the asset management industry, and point out ways to take advantage of their benefits or ease their impact. We can also keep you abreast of the progress of these proposals as they make their way into law.