Budget 2019:
Developments of Note for Compliance Officers

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Budget 2019: Overview

- Pre-election budget
- Few fundamental changes
  - Limited tax revenue enhancements/expenditures
  - “Conceptual” employee stock option proposals
  - Canada Training Credit, SR&ED, Zero-emission vehicle proposals
- Several notable changes impacting investment funds
  - Carrying on business in TFSAs change
  - New “Character Conversion” transaction limitations
  - “Allocation to Redeemers” methodology limitations

“Allocation to Redeemers” Methodology

Background

- The income of “mutual fund trusts” (“**MFTs**”) is subject to tax at the highest marginal tax rate applicable to individuals.
- However, MFTs are generally entitled to claim a deduction in respect of income that is paid or becomes payable to unitholders in a year.
- The trust indentures of most MFTs provide that sufficient income will automatically become payable to unitholders each year to ensure that the MFT “runs flat”.

“Allocation to Redeemers” Methodology

- Double taxation can arise where the unitholder of an MFT redeems his/her units and the MFT needs to dispose of investments to fund the redemption.
  - Potential capital gain earned by the MFT on the disposition of investments ***plus*** a potential capital gain earned by the unitholder on the redemption of his/her units
- Capital gains refund mechanism aimed at relieving double taxation by providing an MFT with a refund upon the redemption of units *(subsection 132(1) of the Tax Act)*.
  - Refund mechanism is imperfect – based on rigid formulae with largely fixed variables

"Allocation to Redeemers" Methodology

- "Allocation to Redeemers" methodology (the "**Methodology**") was developed approximately 20 years ago to overcome deficiencies in the capital gains refund mechanism.
- The Methodology provides that capital gains arising on the sale of investments by an MFT to fund a redemption of units may be solely allocated to the redeeming unitholder.
- The capital gains allocated to the redeeming unitholder are excluded from the unitholder's proceeds of disposition of his/her units *(paragraph 107(2.1)(c) of the Tax Act)*.

“Allocation to Redeemers” Methodology

Example

An MFT has 200 Unitholders, each of whom holds 100 Units. The NAV per Unit is $50 and each Unitholder has an aggregate adjusted cost base in his/her Units of $2,500. Each Unitholder is entitled to redeem his/her Units at the prevailing NAV per Unit.

The MFT solely holds shares of one company, Company X, with an aggregate fair market value of $1,000,000 and an aggregate adjusted cost base of $500,000.

A Unitholder, Sally, wishes to redeem all of her Units. Sally is entitled to $5,000 for her Units; however, the MFT will earn a capital gain of $2,500 when it sells the number of shares of Company X necessary to fund the redemption.

“Allocation to Redeemers” Methodology

Example (cont.)

Under the Methodology, the MFT can allocate the $2,500 capital gain resulting from the sale of the Company X shares solely to Sally.

Sally’s proceeds of disposition of her Units will be reduced by the amount of the allocated capital gain such that her gain on the redemption of her Units will be reduced to nil (i.e., $5,000 (Unit value) <u>minus</u> $2,500 (Allocated capital gain) <u>minus</u> $2,500 (Adjusted cost base)).

Since the gain on the sale of the Company X shares has been allocated solely to Sally, the remaining Unitholders will not bear the tax burden of the disposition.

“Allocation to Redeemers” Methodology

- The Methodology has been approved by the Canada Revenue Agency in a number of past tax rulings (the “**Rulings**”). (e.g., CRA document #9817583, 2000-0041363, 2001-009107A)
- The Rulings provided that neither the specific anti-avoidance rule in subsection 104(7.1) of the Tax Act, nor the GAAR in section 245 of the Tax Act, would apply in respect of the use of the Methodology.
- The Tax Act was amended to properly integrate the Methodology with the capital gains refund mechanism.

“Allocation to Redeemers” Methodology

- The Department of Finance (“**Finance**”) has become concerned that certain MFTs have been applying the Methodology in an abusive manner.
- Specifically, certain MFTs have been allocating what Finance perceives to be excessive capital gains to redeeming unitholders as a means of creating tax deferrals for remaining unitholders.
- Certain MFTs have, in the eyes of Finance, also been disproportionately allocating income to certain redeeming unitholders that hold their units on income account as a means of securing a tax benefit for remaining unitholders.

“Allocation to Redeemers” Methodology

Example

An MFT has 200 Unitholders, each of whom holds 100 Units. The NAV per Unit is $50 and each Unitholder, other than Sally and Sam, has an aggregate adjusted cost base in his/her Units of $2,500. Sally’s aggregate adjusted cost base in her Units is $4,000 and Sam’s aggregate adjusted cost base in his Units is $1,000. Each Unitholder is entitled to redeem his/her Units at the prevailing NAV per Unit.

The MFT solely holds shares of one company, Company X, with an aggregate fair market value of $1,000,000 and an aggregate adjusted cost base of $500,000.

Sally, wishes to redeem all of her Units. Sally is entitled to $5,000 for her Units; however, the MFT will earn a capital gain of $2,500 when it sells the number of shares of Company X necessary to fund the redemption.

“Allocation to Redeemers” Methodology

Example (cont.)

Under the Methodology (pre-Budget amendments), the MFT can allocate the $2,500 capital gain resulting from the sale of the Company X shares solely to Sally.

Sally's proceeds of disposition will be reduced by the amount of the allocated capital gain such that she will incur a ***capital loss*** *of $1,500 on the redemption of her Units (i.e., $5,000 (Unit value) minus $4,000 (Allocated capital gain) minus $2,500 (Adjusted cost base)).*

However, Sally should be able to apply the capital loss of $1,500 against the allocated capital gain of $2,500, leaving her with a net capital gain of $1,000.

“Allocation to Redeemers” Methodology

Example (cont.)

Since the gain on the sale of the Company X shares has been allocated solely to Sally, the remaining Unitholders will not bear the tax burden of the disposition.

The Budget proposals suggest that Finance believes that the other Unitholders should have faced immediate taxation on the remaining $1,500 of the capital gain earned by the MFT.

“Allocation to Redeemers” Methodology

- Budget 2019 introduced draft legislative amendments to address Finance’s concerns, which will apply to taxation years of MFTs beginning on or after March 19, 2019.
- New subsection 132(5.3) of the Tax Act will disallow deductions claimed by an MFT in connection with the redemption of units to the extent that:
  a) the allocation consists of income (other than taxable capital gains); or
  b) the allocation exceeds the capital gain that would have been earned by the unitholder on the redemption of the redeemed unit(s) absent the allocation.

“Allocation to Redeemers” Methodology

Problems with the Budget proposal:

1. The proposal presumes that MFTs can precisely track the adjusted cost base of each Unitholder’s Units
   - Publicly traded Units
   - Debt forgiveness rules
   - Partially tax-deferred rollovers
   - Adjusted cost base averaging rules
2. Substantive policy deficiency
3. Strategic behaviour

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