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Budget 2013 – impact on investment funds

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The 2013 federal budget introduced a number of proposals that will have a significant impact upon the investment funds industry. Clearly, the most important is the proposal to effectively shut down the benefits of structured products that, unfortunately, became widely known as "character conversion funds or products", a term that was used by the Department of Finance in its budget documents. This alert discusses this and other proposals of interest to the industry.

"Character conversion funds or products"

The government has introduced proposals to address its concerns with certain investment strategies undertaken by many mutual funds in order to provide their unitholders with more tax effective returns. One of the government's action steps to improve the integrity of the tax system is "ensuring that derivative transactions cannot be used to convert fully taxable ordinary income into capital gains taxed at a lower rate".

Generally, the strategies involve a fund entering into either a forward sale agreement (a "regular forward") or a forward purchase agreement (a "prepaid forward") in combination with the ownership of Canadian equities. The fund may eventually sell its Canadian equities to realize a capital gain or capital loss that is based upon the performance of a "reference portfolio", rather than the trading price of the equities. In many cases, a fund is able to earn a capital gain in respect of the yield on a portfolio that, if it were held directly by the fund, would generate fully taxable income for the investors in the fund. Such a strategy can be particularly beneficial for investors seeking a return based on a fixed income portfolio and may also provide a tax deferral opportunity.

The budget proposes to treat the return derived from a "derivative forward agreement" in this manner as "ordinary income or loss", thus defeating the objective sought by the forward agreement structure. A derivative forward agreement is generally defined to be an agreement entered into by a taxpayer to purchase or sell a capital property (e.g., the Canadian equities referred to above) where the value to be derived from the forward agreement is determined by reference to something other than that property (e.g., the "reference portfolio" referred to above).

Forward agreements that are subject to the new rules

1. Forward agreements entered into before March 21, 2013

The Notice of Ways and Means Motion (NWMM) provides grandfathering for any forward agreements that were entered into prior to March 21, 2013 provided that the “term” of those agreements is not “extended” on or after March 21, 2013. It will be important for fund managers and their advisors to review existing forward agreements as well as the operations and structure of the funds to determine the “term” of each agreement and which transactions or events subsequent to March 20, 2013 may constitute an “extension” of the agreement. There are a number of possible scenarios to consider, including the following:

- Many forwards “roll over” every 30 or 90 days. Does a “rollover” represent the termination of one forward agreement and the entry into a new forward?
- Can the “size” or notional amount of an existing forward be increased or decreased without constituting the “extension” of the term? For example, as more investors subscribe for units of a fund, can the notional amount of the forward be increased and more baskets of securities be purchased?
- As investors redeem units, a forward agreement is said to be “partially terminated”? Does this mean, again, a new forward agreement for the remaining portion of the forward?

2. Forward agreements entered into or “extended” after March 20, 2013

The NWMM applies to forward agreements that have a term of 181 days or more or agreements that are part of a series of forward agreements that together have a term of 181 days or more. Statutory provisions and case law together effectively provide a very broad meaning to the term “series” and include within that term any transactions entered into in contemplation of the series. It may be very difficult to establish that successive forward agreements are not part of a series.

Consequences of the application of the new rules to a particular forward agreement

Under existing law, a fund that has a regular forward structure should realize a capital gain or capital loss when Canadian equities are transferred to the counterparty in exchange for the return on the reference portfolio. Under a prepaid forward, the fund will receive Canadian equities having a value based upon the reference portfolio from the counterparty. Sometime thereafter, the fund will sell them on the stock exchange to realize a capital gain or loss. The new rules provide that the capital gain or capital loss that would otherwise arise from the disposition of the Canadian equities under either scenario will instead give rise to ordinary income or ordinary loss. In the case of a regular forward, the income or loss will be recognized when the equities are transferred to the counterparty. The income or loss under a prepaid forward will be recognized when the equities are delivered to the fund by the counterparty. The income (loss) will be added to (deducted from) the cost base of the Canadian equities so that the fund will not realize a capital gain (capital loss) on the same transaction.

Impact on mutual fund corporations

It should be relatively straightforward to restructure a mutual fund trust to adapt to the new rules, once any grandfathering benefits expire. The fund manager can return to having the fund own the fixed income or foreign equity funds directly. Things will not be as easy for mutual fund corporations (MFCs). Multi-class switch fund MFCs are ubiquitous within the Canadian mutual fund industry. In order to provide a complete solution for retail investors, it is desirable to have fixed income products within the switch fund (e.g., bond funds, balanced funds, etc.). However, an MFC is not a flow-through entity for ordinary income. Mutual fund managers will be required to assess the status and portfolio make-up of their MFCs to determine the potential impact of not having the forward structure in place anymore and to consider alternatives for restructuring the fund to avoid incurring non-refundable income tax.

Funds with losses – proposals regarding "trust loss trading"

There have been many situations where a mutual fund did not perform well and the fund incurred substantial non-capital losses or, more commonly, capital losses. One option for a fund manager in this case would be to consider changing the investment mandate of the fund. Existing unitholders could redeem out of the fund, in whole or in part, in response to such a proposal (e.g., if they were not interested in the new mandate or had just lost faith in the manager). The fund manager would want to use the fund's non-capital losses or capital losses carried forward to shelter the income and gains to be derived under the new mandate. Under existing law, there are no rules that would restrict the use of a trust's losses in such a circumstance. The budget proposes to introduce rules that will restrict the utilization of losses of a trust, in a manner somewhat similar to the "acquisition of control" rules that apply to corporations. However, in the trust context, losses will be restricted when there is an acquisition of more than 50% of the trust's equity (rather than an acquisition of *de jure* control which applies to corporations). Fund managers will be required to consider such rules in order to determine whether a fund's losses may be carried forward in such a scenario.

Proposal to revise Form T1135

The prescribed Form T1135 must be filed by unit trusts (other than mutual fund trusts) and certain partnerships where the trust or partnership holds more than $100,000 of "specified foreign property" during the year. The form is relatively easy to complete, as there are only a few boxes to tick off and one line on which to report the amount of the income or loss from all such property for the year. The budget proposes to revise Form T1135 to require considerably more disclosure, effective for the 2013 and subsequent taxation years. The additional disclosure is expected to include information with respect to each specified foreign property, including the name of the investee company or entity holding funds outside Canada, the country to which the property relates and the foreign income generated from the property. Depending upon the degree of granularity required, the compliance burden on certain funds could be considerable.

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