

BUDGET 2016: NEW RULES GOVERNING THE TAXATION OF "SWITCH FUND" SHARES

Posted on March 31, 2016

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In Budget 2016, the new federal Government announced its intention to end a tax deferral opportunity that has historically permitted investors in a mutual fund corporation to "switch" their exposure between the corporation's various portfolios on a tax-deferred basis.

Background

Mutual funds in Canada are generally constituted as either mutual fund trusts or mutual fund corporations. While the majority of funds are constituted as mutual fund trusts, it has been reported that mutual fund corporations currently hold approximately \$120 billion of assets under management, representing approximately 10 per cent of the total mutual fund assets under management in Canada.

Mutual fund corporations frequently have multiple classes of shares, each tracking a different portfolio of assets, with each such class generally being treated as a separate mutual fund for certain securities regulatory purposes. (Such mutual fund corporations are sometimes referred to as "Switch Funds".) For example, a single mutual fund corporation might have a class of shares that is linked to a dividend-focused equity portfolio, and a separate class of shares linked to a growth-focused equity portfolio. A key feature of such arrangements is that investors holding their shares on capital account can generally exchange some or all of their shares in a class for shares in another class of the corporation on a tax-deferred "rollover" basis, pursuant to section 51 of the *Income Tax Act* (the "**Tax Act**"), thereby obtaining exposure to a different pool of investments on a tax-deferred basis.

By contrast, in the majority of cases, mutual fund trusts have only a single portfolio of assets under management. There is generally no mechanism available to investors in a particular mutual fund trust to change their exposure to a different portfolio of assets, on a tax-deferred basis, by exchanging their units for units in a different mutual fund trust. Similarly, there is generally no mechanism under the Tax Act equivalent to section 51 that would permit investors in a mutual fund trust to switch between classes of a particular fund on a tax-deferred basis. (Certain published administrative statements of the Canada Revenue Agency indicate that an investor's units in a mutual fund trust may be re-designated to another class of units of the trust on a

tax-deferred basis in certain limited circumstances, such as where the distinction between the classes is solely attributable to the applicable management fee, rather than being attributable to the underlying investment portfolio).

Budget Proposals

The Government announced its intention in Budget 2016 to amend the Tax Act so that exchanges of mutual fund corporation shares that result in an investor switching exposure between portfolios will be considered to be a disposition at fair market value for tax purposes. The Government announced that the measure would not apply to switches between classes of shares where the only difference between the shares was attributable to the relative management fees or expenses to be borne by investors in the classes of shares (e.g., where the switch is between different series of the same class of shares).

Budget 2016 states that this proposal will apply to dispositions of mutual fund corporation shares that occur after September 2016.

Budget 2016 did not provide draft legislation or otherwise elaborate on the technical aspects of the proposed change. Presumably, any deemed disposition of shares at fair market value pursuant to the proposed legislation would be deemed to constitute a redemption of shares for the purpose of calculating the mutual fund corporation's capital gains refund. However, the Government will need to produce draft legislation before any such determination can be made.

Impact

Once implemented, the Budget proposals relating to "switch funds" will remove a key advantage available to taxable investors investing in mutual fund corporations as compared with taxable investors investing in mutual fund trusts or through the direct ownership of securities. Further weighing against the use of mutual fund corporations is the relative tax inefficiency, as compared with mutual fund trusts or the direct holding of securities, of deriving foreign source income and interest income through a mutual fund corporation.

Notwithstanding the above, there are various features associated with mutual fund corporations that suggest many mutual funds will continue to be constituted in the corporate form. One such feature that will not be affected by the Budget proposals is the ability to pool expenses, income and losses attributable to the various funds held by a mutual fund corporation. Because the mutual fund corporation is a single taxpayer, losses derived by one of the funds in the corporation may be available to offset gains derived by another fund in the corporation, resulting in possible net efficiencies across the investors as a whole. Similarly, the capital gains refund entitlement of a mutual fund corporation is not calculated on a class-by-class basis but is instead calculated on a corporation-by-corporation basis.

Budget 2016 was silent on whether a mechanism would be made available to mutual fund corporations that wish to be split into separate mutual fund trusts on a tax-deferred basis. Once the draft legislation to implement the Budget proposals is released, managers should evaluate the pros and cons of maintaining their current structure and assess their options for the future. In the meantime, managers will need to assess whether it is necessary to issue a notice to their investors in connection with the Budget proposals or whether their tax disclosure should be updated.

Taxable investors holding shares in mutual fund corporations on capital account, on the other hand, should consider whether their portfolio needs to be rebalanced prior to the implementation of the proposals at the beginning of October 2016.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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