BUDGET 2017: NEW RULES GOVERNING THE TAXATION OF SEGREGATED FUNDS

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In Budget 2017, the federal Government announced its intention to modernize the rules relating to the taxation of segregated funds by permitting such funds to (i) apply non-capital losses to reduce income earned in other years, and (ii) effect mergers on a tax-deferred basis.

Background

Segregated fund arrangements are life insurance policies under which all or a portion of the return to the insured varies depending on the fair market value of an underlying group of properties.

Segregated funds share a host of common characteristics with conventional mutual funds. Nevertheless, there are certain unique advantages offered to a holder of a segregated fund policy, including (i) the return of a guaranteed minimum amount at the maturity of the policy or on the death of the policyholder, and (ii) a special degree of protection provided under provincial insurance laws that may exclude both a segregated fund policy, and any insurance proceeds from the policy, from creditor claims in the event of the policyholder's insolvency.

The current statutory rules governing the taxation of segregated funds have remained largely unchanged since they were introduced by the federal Government in its 1977 Budget. While the property associated with a segregated fund arrangement is technically held by the insurer, section 138.1 of the *Income Tax Act* (the "**Tax Act**") deems (i) such property to be held in a trust, (ii) the relevant policyholders to be beneficiaries of the trust, and (iii) the insurer to be the trustee of the trust (each such trust being a "**Segregated Fund**").

The rules in the Tax Act governing the taxation of conventional commercial trusts apply to Segregated Funds. The Tax Act provides that the income of a Segregated Fund is deemed to become payable each year to the beneficiaries of the Segregated Fund. In accordance with the general rules in the Tax Act relating to the taxation of trusts, the amounts deemed payable to a beneficiary of a Segregated Fund are thereafter required to be included in computing the taxable income of the beneficiary in respect of the taxation year. The Tax Act further deems any capital gain or capital loss from the disposition of property earned or incurred by a Segregated Fund to be a capital gain or capital loss, as applicable, of the beneficiaries of the Segregated Fund

and not the Segregated Fund itself.

Budget Proposals

Budget 2017 proposed two material amendments to the rules governing the taxation of Segregated Funds.

(i) New Loss Application Rules

When the amendments proposed in Budget 2017 come into force, non-capital losses that are incurred by a Segregated Fund in a particular taxation year will be permitted to be applied to reduce the taxable income of the Segregated Fund in previous or subsequent taxation years (in accordance with the normal loss carry-forward and carry-back rules contained in the Tax Act).

As previously noted, the income of a Segregated Fund is currently deemed to be payable each year to the beneficiaries of the Segregated Fund. Under the Tax Act, when a conventional commercial trust declares its income payable to its beneficiaries, it is entitled to claim a deduction when computing its income equal to the amounts that have become payable to its beneficiaries. As a consequence, most Segregated Funds run "flat" (i.e., the deductions claimed in respect of amounts payable to their beneficiaries equal their income for the year) such that Segregated Funds themselves are not subject to general income tax.

The Notice of Ways and Means Motion that accompanied the introduction of Budget 2017 did not contain the detailed text of all of the legislative amendments that are proposed to be enacted to permit the non-capital losses of a Segregated Fund to be applied in respect of other taxation years. While the ability to apply non-capital losses incurred in a particular taxation year to reduce the income of a Segregated Fund in a subsequent year will be a welcome change, as a practical matter, most Segregated Funds will not be able to carry-back losses to reduce income in previous taxation years, despite the technical ability to do so.

Given that the income of a Segregated Fund is declared payable to its beneficiaries each year (and is thus included in computing the income of each beneficiary of the Segregated Fund each year), the process of carrying back losses is quite onerous. Among other things, a Segregated Fund would be required to issue revised T3 slips to each beneficiary of the Segregated Fund, and each beneficiary of the Segregated Fund would be required to amend his/her tax return to claim a refund. Conventional mutual fund trusts have long faced similar obstacles, which has resulted in most mutual fund trusts opting not to carry-back losses, even when it was possible to do so.

The new loss application rules in respect of Segregated Funds are proposed to apply only in respect of losses incurred in taxation years that begin on or after January 1, 2018.

(ii) Segregated Fund Merger Rules

Budget 2017 also proposed the introduction of rules that will permit Segregated Funds to merge with one another on a tax-deferred basis.

Historically, insurers have been required to maintain the separate existence of individual Segregated Funds even where the number of remaining policyholders had been dramatically reduced as a consequence of the deaths of policyholders and periodic redemptions.

To better ensure the consistent treatment of mutual fund trusts and Segregated Funds, the Government proposes to amend section 138.1 of the Tax Act to introduce merger provisions that largely parallel the merger rules that currently apply to mutual fund trusts (as set out in section 132.2 of the Tax Act).

The proposed Segregated Fund merger rules will permit one Segregated Fund to combine with another Segregated Fund on a rollover basis. Where the proposed rules apply, the property of a Segregated Fund may be transferred to another Segregated Fund on a tax-deferred basis, provided an election is made by the later of six months after the day that includes the transfer time, and a day that the Minister of National Revenue may specify.

Upon a merger of two Segregated Funds, the proposed merger rules contemplate that 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, at an amount equal to the lesser of:

a. the fair market value of the property immediately before the transfer time; and
b. the greater of:

    i. the cost amount of the property immediately before the transfer time; and
    ii. the amount that is designated in respect of the property by the Segregated Funds in the election made in respect of the merger.

Capital losses arising from such deemed dispositions may only be applied against capital gains emanating from the deemed dispositions.

Trustees of Segregated Funds with property that has significant accrued losses will need to carefully consider whether such losses may disappear as a result of a contemplated merger. (As a means of utilizing capital losses that may arise on the deemed disposition of property in connection with a merger, the insurer may wish to selectively trigger accrued gains associated with the other property of the Segregated Fund in order to absorb available capital losses.)

Much like the existing rules governing the merger of mutual fund trusts, the loss balances of a Segregated Fund for periods prior to a merger may not be carried forward and applied by the merged fund in respect of

subsequent taxation years.

The new Segregated Fund merger rules are proposed to come into force in respect of mergers that occur on or after January 1, 2018.

Stakeholder Consultations

Budget 2017 acknowledged that the proposed amendments relating to Segregated Funds may give rise to unique or unanticipated consequences. Accordingly, the Government has invited stakeholders in the life insurance community to provide comments on the proposed measures.

Insurance companies that issue and administer segregated fund policies should consider the characteristics of their policies, and whether there may be any impediment to the merger of their Segregated Funds in the future under the proposed rules. To the extent that the special attributes of one or more segregated fund policies maintained by an insurance company would preclude a merger under the new proposed regime, the insurer should make representations to the Government to address such issues at the earliest opportunity.

by Michael Friedman

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.