BUDGET 2019: CRA REFINES MUTUAL FUND ALLOCATION TO REDEEMERS METHODOLOGY AND TIGHTENS RULES ON TFSAS

Posted on April 1, 2019

Categories: Insights, Publications

Budget 2019, released on March 19, 2019, proposes new rules to combat tax strategies perceived by the Government to be employed by certain mutual fund trusts to disproportionately allocate capital gains and/or income to redeeming unitholders under the so-called "allocation to redeemers methodology".

Background

Although a mutual fund trust is considered to be a separate taxpayer under the *Income Tax Act* (Canada) (the "**Tax Act**"), various provisions of the Tax Act have the collective effect of permitting managers of mutual fund trusts to administer the trust in a manner that largely permits the trust to operate like a flow-through vehicle for tax purposes – a practical necessity for collective investment vehicles. For example, if a mutual fund trust makes distributions to its unitholders in a year, the mutual fund trust will generally be entitled to retain a deduction for such allocated amounts in computing its taxable income. This allows a mutual fund trust to reduce its taxable income to zero (i.e., run "flat"), which is of great importance because commercial trusts are generally subject to Canadian income tax at the highest marginal rate applicable to individuals. Similarly, a mutual fund trust may make certain designations in respect of distributions to unitholders, which permit the character of amounts earned by the mutual fund trust, such as capital gains, Canadian dividends and foreign source income earned by the trust to effectively flow through to the unitholders. Managers of mutual fund trusts customarily ensure that all of a mutual fund trust's income and capital gains are distributed, or deemed to be distributed, to unitholders each year to ensure that no tax is payable by the trust under Part I of the Tax Act.

When a mutual fund trust unitholder redeems his or her units, the trust often must dispose of investments to fund the redemption, potentially causing the trust to realize accrued gains on such asset sales. The redeeming unitholder may also realize a corresponding gain on the redemption of his or her mutual fund units. Accordingly, the same economic gain could be taxed twice – once in the hands of the trust and once in the hands of the redeeming unitholder.

Subsection 132(1) of the Tax Act provides a capital gains refund mechanism to limit such "double taxation" by providing the trust with a refund of an amount approximating the trust's tax payable in respect of the disposition of assets to fund a redemption. However, the capital gains refund mechanism found in the Tax Act is a rigid, formulaic approximation and does not always fully relieve such double taxation.

As an alternative, mutual fund trusts often use the "allocation to redeemers methodology" to more precisely allocate the capital gains realized by the mutual fund trust to fund a redemption to redeeming unitholders. This methodology allows a mutual fund trust to allocate such capital gains to a redeeming unitholder and claim a corresponding deduction. The allocated capital gains are included in computing the redeeming unitholder's income and the unitholder's redemption proceeds are reduced by a corresponding amount.

The Canada Revenue Agency (the "**CRA**") has repeatedly issued advance tax rulings permitting this practice over the last 20 years, recognizing that it provides for a more equitable allocation of capital gains to unitholders and a more effective means of avoiding double taxation than is available under the capital gains refund mechanism.[1]

Budget 2019 alleges that certain mutual funds have been misusing the allocation to redeemers methodology to obtain inappropriate tax deferrals and/or inappropriately alter the character of amounts properly allocated to unitholders.

Deferral

Budget 2019 alleges that certain mutual fund trusts have been using the allocation to redeemers methodology to allocate capital gains to redeeming unitholders in excess of the capital gains that would otherwise have been realized by such unitholders on the redemption of their units, resulting in a deferral benefit to remaining unitholders.

Where a redeeming unitholder is allocated an amount on a redemption that exceeds the capital gain that would otherwise have been realized by such unitholder (such portion being described in Budget 2019 as the "**excess portion**"), Budget 2019 notes the following tax consequences would arise:

- The mutual fund trust is permitted a deduction in respect of the full allocated amount.
- The redeeming unitholder is subject to tax on an amount equivalent to the amount upon which he or she would have been subject to tax if no such allocation were made.[2]
- Since the trust does not need to allocate the excess portion to the remaining unitholders, the remaining unitholders effectively have an unrealized gain in their units that will not be realized until the units are redeemed.

Budget 2019 calls this deferral "inappropriate" and proposes to introduce a new anti-avoidance rule in subsection 132(5.3) of the Tax Act that would deny a mutual fund trust a deduction for the excess portion if (1) the allocated amount is a capital gain, and (2) the unitholder's redemption proceeds are reduced by the allocation.

As noted in the commentary below, some mutual fund trusts may find it difficult or impossible to comply with proposed subsection 132(5.3) of the Tax Act.

This measure will apply to taxation years of mutual fund trusts that begin after March 18, 2019.

Character Conversion

Certain mutual fund trusts have reportedly also been using the allocation to redeemers methodology in a manner that allows the mutual fund trust to convert the returns on an investment that would have the character of ordinary income to capital gains for the fund's remaining unitholders.

This character conversion planning is possible when the redeeming unitholders hold their units on income account (or are tax-exempt) and are allocated ordinary income rather than capital gains under the allocation to redeemers methodology. Where the remaining unitholders hold their units on capital account, the trust will have effectively "streamed" income to the redeeming income account unitholders, allowing a disproportionate amount of capital gains to be allocated to the remaining unitholders.

Proposed subsection 132(5.3) of the Tax Act would deny a mutual fund trust a deduction in respect of an allocation made to a unitholder on a redemption, if (1) the allocated amount is ordinary income, and (2) the unitholder's redemption proceeds are reduced by the allocation.

The Government indicated in Budget 2019 that it was of the view that such planning could be challenged by the Government based on existing rules in the Tax Act, but asserted that a specific anti-avoidance measure was necessary to reduce time-consuming and costly challenges under the existing rules.

This measure will apply to taxation years of mutual fund trusts that begin after March 18, 2019.

Commentary

The Government estimates that the foregoing tax measure will generate $25 million in additional tax revenue 2019-20 and $105 million in 2020-2021. However, it is not clear whether the practical effect of the measure will be that mutual fund trusts will have to cease using the allocation to redeemers methodology.

Some mutual fund trusts may find it difficult or impossible to comply with proposed subsection 132(5.3) of the Tax Act. To comply with this proposed measure, a mutual fund trust will need to be able to track the adjusted cost base of a redeeming unitholder's units. This may prove to be difficult or impossible for some mutual fund trusts, particularly those whose units are listed on a stock exchange and/or are held in brokerage accounts.

Trustees and managers of mutual fund trusts may not know the identity of unitholders when units are held in brokerage accounts, and unitholders may hold units in multiple accounts with different brokers such that the adjusted cost base averaging rules would apply. Factors unknown to a fund manager may also affect the calculation of a unitholder's cost amount, such as the debt forgiveness rules, the superficial loss rules, and various rollover provisions in the Tax Act.

Moreover, it is possible that units of a mutual fund trust may have to deduct a discount on the secondary market to reflect accrued gains at the trust level. The new proposed anti-avoidance measure may have the effect of precluding the allocation of the full amount of gains to the person who rightly should bear such gain for tax purposes.

Mutual fund trusts that abandon the allocation to redeemers methodology will be forced to mitigate against double taxation by relying on the capital gains refund mechanism, even though Budget 2019 acknowledges that the mechanism does not relieve all instances of double taxation. Interestingly, Budget 2019 did not introduce any corresponding measures to improve the capital gains refund mechanism, while effectively foreclosing the ability of certain mutual fund trusts to adopt the allocation to redeemers methodology.

The denial of the deduction for income allocable to a redeeming unitholder may itself lead to arbitrage opportunities: unitholders with large positions on capital account may redeem units before the end of a year to avoid large income distributions at the end of the year.

In addition, of note, the proposed measure in subsection 132(5.3) of the Tax Act applies only to mutual fund trusts and not to investment trusts generally.

Carrying on Business in a TFSA

A tax-free savings account under the Tax Act (a "**TFSA**") is a registered account that is eligible to earn certain investment income on a tax-exempt basis. However, a TFSA that earns income from carrying on a business (such as the business of trading securities) or from non-qualified investments remains subject to tax under Part I of the Tax Act.

A TFSA is generally constituted as a trust with a financial institution serving as the trustee. A TFSA is generally subject to tax under Part I of the Tax Act in respect of income of the TFSA earned from carrying on a business (e.g., an active stock trading business).[3] The trustee of a TFSA is jointly and severally liable with the TFSA for any Part I tax for which the TFSA is liable. Conversely, the individual holder of the TFSA is not jointly and severally liable with the TFSA for any such Part I tax liability, but is liable for any tax imposed under Part XI.01 of the Tax Act in respect of the acquisition of non-qualified or prohibited investments by the TFSA. The absence of a holder's joint and several liability in respect of Part I tax liabilities under the existing rules is notable since the

TFSA holder generally directs the activities performed by the TFSA that could be said to constitute the carrying on of a business – indeed, the holder, and not the financial institution, would often be the directing mind behind any such business activity.

Trustees could face exposure under the existing rules if a TFSA with a Part I tax liability from carrying on a business does not have sufficient assets within the TFSA for the trustee to satisfy the Part I tax liability (for example, because the TFSA holder has withdrawn the funds or transferred them to a different financial institution).

Budget 2019 responds to concerns raised by the financial industry about the inequity of the above treatment by limiting the joint and several liability imposed upon the trustee of a TFSA at a particular time to the amount of property held within the TFSA at that time plus any amounts distributed out of the TFSA on or after the date that a notice of assessment is sent in respect of such Part I tax liability. Budget 2019 also proposes to impose joint and several liability for any Part I tax liability of the TFSA on both the trustee and the holder of the TFSA.

Although the proposals go some way to addressing the concerns of trustees, trustees continue to have exposure to certain Part I tax attributable to the business activities of a TFSA. The proposed limits on trustees' joint and several liability would not extend to amounts distributed out of the TFSA after a notice of assessment for Part I tax is sent by the CRA to the trustee. Subsection 244(14) of the Tax Act establishes a presumption that a notice of assessment is sent on the date of the assessment. It is not uncommon for a week or more to pass between the date of an assessment and receipt of the assessment through the mail – time during which a holder of a TFSA could extract funds from a TFSA and for which the trustee could be held jointly and severally liable. To minimize such exposure, trustees should review their internal procedures to ensure that a notice of assessment is promptly acted upon following receipt. In addition, consideration should be given by financial institutions to institute moratoriums on distributions from a TFSA whenever a proposal letter is received from the CRA in respect of a TFSA indicating that a Notice of Assessment may be forthcoming.

These proposals will apply to the 2019 and subsequent taxation years.

by Andrew Stirling and Reuben Rothstein, Articling Student

[1] See, for example, CRA, Document nos. 9817583 (1999); 2000-0041363 (2000), and 2001-009107A (2002).
[2] The allocated amounts reduces the unitholder's redemption proceeds. Accordingly, a portion of the allocated amount effectively eliminates the capital gain that would have been realized on the redemption of the units. The balance of the allocated amount, representing the so-called "excess portion", results in the unitholder realizing a capital loss on the redemption equal to the excess portion, which offsets the inclusion of the excess portion in the redeeming unitholder's income as a consequence of the trust allocation.
[3] See subsection 146.2(6) of the Tax Act.

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.