

NEW PROPOSED LEGISLATION TO REFINE MUTUAL FUND "ALLOCATION TO REDEEMERS" METHODOLOGY

Posted on July 30, 2019

Categories: [Insights](#), [Publications](#)

Budget 2019 proposed new rules to combat tax strategies employed by certain mutual fund trusts to disproportionately allocate capital gains to redeeming unitholders under the so-called "allocation to redeemers" methodology. (Our analysis of this Budget measure can be found [here](#).)

On July 30, 2019, the Department of Finance released revised proposed amendments to the *Income Tax Act* (Canada) (the "**Tax Act**") to limit the circumstances under which the "allocation to redeemers" methodology may be employed (the "**Proposed Legislation**"). The Proposed Legislation contains welcome revisions to the original legislative proposals introduced in Budget 2019.

Background

When a mutual fund trust unitholder redeems his or her units, the trust often must dispose of assets 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 in the Tax Act is predicated on rigid, formulaic approximations and does not always fully relieve double taxation.

As an alternative, mutual fund trusts often use the "allocation to redeemers" methodology to more precisely allocate the capital gains realized by a mutual fund trust to fund redemptions. This methodology allows a mutual fund trust to allocate 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.

Budget 2019 alleged 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. Budget 2019 proposed 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 proposed in Budget 2019, the manager of a mutual fund trust would have been required to have tracked the "cost amount" of a redeeming unitholder's units so as to be able to compute the gain arising on the redemption of the units (see variable D of the formula in the originally proposed version of paragraph 132(5.3)(b)). This would have proved 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.

The Budget 2019 proposals may have had the practical effect of precluding the allocation of the full amount of gains to redeeming unitholders, who rightly should bear such gains for tax purposes.

Proposed Legislation

The Proposed Legislation tempers, to some degree, the proposed amendments that were included in Budget 2019. It does so by introducing a "reasonable efforts" standard that will limit the obligations of the trustee of a mutual fund trust to determine the "cost amount" of units held by a redeeming unitholder. Specifically, variable D of the formula in proposed paragraph 132(5.3)(b) now refers to the amount "determined by the trustee to be the beneficiary's cost amount of that unit, using reasonable efforts to obtain the information required to determine the cost amount". Previously, variable D simply referred to the beneficiary's "cost amount" of the unit being redeemed.

The Explanatory Notes to the Proposed Legislation provide some detail on what the Department of Finance views as "reasonable efforts" in this context. The Department of Finance observes that the starting point for determining the "cost amount" of units for the purposes of subsection 132(5.3) are the initial subscription prices paid when the units are acquired, as modified by any relevant transactions involving the units to which the mutual fund trust is a party. In the absence of such information, mutual fund trusts are expected to make reasonable efforts to obtain this information, including through inquiries of third parties or through a search of relevant records.

The Department of Finance confirmed that mutual fund trusts are not expected to make inquiries regarding external factors (such as events or transactions that did not involve the mutual fund trust) unless the mutual fund trust has reason to believe that such external factors exist and could affect the cost amount of the units.

The Proposed Legislation also delays the application aspects of the new anti-avoidance rule to mutual fund trusts that are listed on a designated stock exchange in Canada and are in continuous distribution. For these mutual fund trusts, the new rules in respect of the allocation of capital gains are only proposed to apply in respect of taxation years of the trusts beginning after March 19, 2020. For all other mutual fund trusts, the proposed rules will apply in respect of taxation years that begin after March 18, 2019.

The Proposed Legislation represents a substantive improvement over the proposed amendments introduced in Budget 2019. However, the burden on trustees/managers of mutual fund trusts to track and determine the “cost amount” of units held by investors has not been entirely eliminated, and uncertainty will now arise in assessing what will constitute “reasonable efforts” in varying circumstances. As a result, practical challenges in fully and defensibly applying the “allocation to redeemers” methodology in the future may endure.

by Michael Friedman and Ehsan Wahidie

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.

© McMillan LLP 2019