CAPITAL GAINS CONFUSION: THE REPORTING CONUNDRUM FOR INVESTMENT FUNDS

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In the 2024 Federal Budget, the Government announced its intention to increase the capital gains inclusion rate in respect of capital gains arising on or after June 25, 2024 (the "**Capital Gains Changes**"). Proposed amendments to the *Income Tax Act* (Canada) (the "**Tax Act**") were included in a Notice of Ways and Means Motion that was brought before Parliament on September 23, 2024 (the "**September NWMM**"). However, Parliament was recently prorogued, which has cast the future of the Capital Gains Changes in doubt.

Although the Capital Gains Changes have not been enacted into law, the Canada Revenue Agency (the "**CRA**") has asserted that it will administer the Tax Act on the assumption that the Capital Gains Changes will ultimately be enacted with retroactive effect. The CRA justifies its position on the basis that the Capital Gains Changes were included in the September NWMM, and the Government has not signaled an intention to abandon the proposed amendments.

Investment funds that are constituted as trusts are generally required to file T3 returns, and issue T3 reporting slips, within 90 days of the end of a taxation year. T3 returns report, among other things, the amount of income of the trust that became payable to unitholders in the year and the portion of such income that represented taxable capital gains that were designated in respect of unitholders. It is not expected that the Government, the CRA, or the Department of Finance will provide further substantive guidance on the potential application of the Capital Gains Changes prior to trusts having to file their T3 returns in respect of the 2024 taxation year.

This bulletin briefly summarizes (i) some of the considerations that investment funds should weigh in determining whether to complete their T3 returns on the basis of the Capital Gains Changes or the law as it currently stands, and (ii) the underlying rationale for the CRA's position that it should administer the Tax Act as if the Capital Gains Changes have been enacted into law.

2024 T3 Reporting for Investment Funds

Unfortunately, any approach to reporting taxable capital gains in a trust's 2024 T3 return potentially attracts future difficulties. If a trust assumes that taxable capital gains are to be computed on the basis of the Capital Gains Changes, and the Capital Gains Changes are not ultimately enacted into law, the taxable income

reported by the trust, or declared payable to unitholders, may exceed the income actually earned by the trust. Conversely, if a trust computes its taxable capital gains on the basis of the current provisions of the Tax Act, and the Capital Gains Changes are ultimately enacted, the trust may have under-reported its income, potentially attracting penalties and interest.

When deciding how to compute and report taxable capital gains for 2024, an investment fund should consider several factors, including the following:

What requirements are set out in the investment fund's Declaration of Trust?

Specific consideration should be given to the provisions of the investment fund's Declaration of Trust that govern the computation of income, the declaration of income payable to unitholders, and the designation of taxable capital gains in respect of unitholders. The discretion of the trustee to select a particular reporting approach, and the ability to later take corrective steps when the status of the Capital Gains Changes is ultimately clarified, may be restricted by the fund's Declaration of Trust.

How will the reporting of the taxable capital gains of the investment fund be affected by the special transitional rules set out in the September NWMM?

The Capital Gains Changes include special transitional rules that modify the reporting and computation of taxable capital gains declared payable by a trust and designated in respect of a unitholder in 2024. The transitional rules are intended to address the fact that different inclusion rates are proposed to apply in respect of capital gains earned in 2024, depending on whether they resulted from dispositions that occurred before, or on or after, June 25, 2024.

Special consideration should be given to proposed subsections 104(21.4) through (21.8) of the Tax Act, and pro forma tax calculations should be prepared, to determine whether the application of the transitional rules will result in a unitholder of the investment fund having the discretion to effectively determine what inclusion rate is applied to taxable capital gains declared payable to the unitholder by the investment fund in 2024.

In addition, given that the CRA has indicated that it intends to prepare all 2024 tax forms on the basis of the Capital Gains Changes, it may be easier for unitholders to comply with their tax reporting obligations if the investment fund follows the lead of the CRA and reports on the basis of the Capital Gains Changes.

What are the adjusted cost bases of the units of the investment fund held by unitholders?

Typically, a unitholder will be required to reduce the adjusted cost base of its units of an investment fund to the extent the distributions made to the unitholder by the investment fund exceed the taxable income payable to the unitholder and certain other amounts. If an investment fund were to pay an excessive amount to a

unitholder in a year (e.g., make distributions on the basis of the Capital Gains Changes and such changes are not ultimately enacted), and it was subsequently determined that the quantum of such distributions was higher than required, the adjusted cost base of the unitholder's units may be reduced. To the extent that a required reduction results in the adjusted cost base of a unitholder's units becoming a negative amount, a taxable capital gain could inadvertently be triggered.

The Capital Gains Changes and the CRA's Administrative Assessing Position

The CRA has taken the position that because the Government included the Capital Gains Changes in the September NWMM and has not publicly resiled from that position, it must administer the Tax Act as if the Capital Gains Changes have been enacted into law. The position of the CRA is premised on its understanding of legislative practice and historical custom.

Before the Government introduces a bill to impose a new tax, increase an existing tax, continue an expiring tax, or extend the coverage of a tax, it must introduce a Notice of Ways and Means Motion (a "**NWMM**") in the House of Commons.[1] A NWMM is not subject to debate or amendment, since it is adopted by the House of Commons on concurrence.[2] Concurrence on a NWMM represents an order to bring forward draft legislation, which must be based on, but not necessarily be identical to, the NWMM.[3] If a draft bill were found to exceed the limits of the supporting NWMM, a new NWMM would be required to authorize the bill.[4]

A NWMM can only be tabled by a Minister, a requirement rooted in the *Constitution Act, 1867*, which provides that bills imposing any tax originate in the House of Commons.[5] Amendments to the Tax Act are often proposed in conjunction with the annual Federal Budget, with the Minister of Finance tabling a NWMM that sets out the taxation changes required to implement the government's fiscal plan.[6]

While it is long-standing practice that the tabling of a NWMM provides provisional authority for the CRA to administer and enforce proposed tax measures,[7] the origins of this practice are not clear. Importantly, the provisional implementation of taxes is not supported by any legislation. The payment and collection of these taxes is voluntary and legally cannot be enforced.[8],[9] Rather, it is merely a convention justified by the desire to ensure the effectiveness of new tax measures, assist the Minister of Finance in forecasting expected revenues, and limit unintended advantages to certain taxpayers.[10]

Efforts have been made in the past to address the questionable legal basis for the provisional implementation of tax measures. In 1985, then Minister of Finance Michael Wilson issued a paper proposing a new bill that would provide legal authority for the government to provisionally enforce tax measures. The paper contained a draft bill requiring taxpayers to pay, file, and remit taxes on the basis of proposed tax measures. However, when considering the paper later that year, Parliament's Standing Committee on Procedures and Organization was opposed on principle to the collection of taxes without the authority of Parliament, and the bill was not

enacted.[11]

Since the Capital Gains Changes were included in the September NWMM, but have not been enacted into law, taxpayers have been left in the position of having to choose to either file and pay taxes based on the September NWMM or based on the existing law as it currently stands. Taxpayers may find some comfort in the CRA's audit guidelines, which state that taxpayers cannot be required to file on the basis of proposed legislation. Yet, this is of little consolation if the Capital Gains Changes are enacted retroactively, since taxpayers would then be required to amend their returns based on the enacted legislation and may be subject to interest and penalties.[12]

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Investment funds have been placed in an extremely awkward position. They must select and adopt a reporting practice based either on (i) an administrative position of the CRA that is not consistent with the law as it currently stands, or (ii) the law, as currently enacted, which is not consistent with the administrative approach adopted by the CRA.

It is hoped that the CRA will grant taxpayers some degree of discretionary relief from interest and penalties if corrective action is required to be taken when the status of the Capital Gains Changes is resolved. Unfortunately, no comfort has been provided by the CRA in this regard to date.

[1] Michael Lukyniuk, "*Tax Bills and the Ways and Means Process*" at 26.
[2] House of Commons Standing Order 83(3).
[3] House of Commons Standing Order 83(4).
[4] *House of Commons Procedure and Practice, 2000 Edition* Chapter 18 "The Business of Ways and Means."
[5] R.S.C. 1985, Appendix II, No. 5, s. 53.
[6] Michael Lukyniuk, "*Tax Bills and the Ways and Means Process*" at 26.
[7] Library of Parliament HillStudies: *The Parliamentary Financial Cycle* (Publication No. 2015-41-E) at 8.
[8] Auditor General of Canada, *Report to the House of Commons for the Fiscal Year Ended 31 March 1991* at 2.69.
[9] Canada Revenue Agency, *Income Tax Audit Manual* Chapter 12 at 12.3.4.
[10] Library of Parliament HillStudies: *The Parliamentary Financial Cycle* (Publication No. 2015-41-E) at 8.
[11] Auditor General of Canada, *Report to the House of Commons for the Fiscal Year Ended 31 March 1991* at 2.75-2.76.
[12] Canada Revenue Agency, *Income Tax Audit Manual* Chapter 12 at 12.3.5.

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A Cautionary Note