



Preparing for the Unexpected: Tax Traps for Investment Funds in the Midst of the COVID-19 Pandemic

PMAC Webinar

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Agenda

1. Preserving “Mutual Fund Trust” Status
 - Qualification Requirements
 - Confirming/Bringing Funds Back into Compliance
 - Implications of a Fund Ceasing to be a Mutual Fund Trust
2. “Prohibited Investment” Issues
 - Redemptions Causing Existing Investors to have a “Significant Interest” in a Fund
3. Partnerships and “Carried Interest” Issues
4. Questions



Preserving “Mutual Fund Trust” Status

MFT Qualification Requirements: A Primer

“Mutual Fund Trust” Status

- Legal tests set out in subsection 132(6) of the ITA (with reference to subsection 108(2) of the ITA and Part XLVIII of the *Income Tax Regulations* (the “**Regulations**”))
- The applicable legal tests are point in time tests
- Primary tests:
 - The trust must be a “unit trust” resident in Canada;
 - The trust’s only undertaking must be investing its funds in property or conducting certain activities in respect of real property that is held as capital property
 - The trust must comply with certain “prescribed conditions”

MFT Qualification Requirements: A Primer

“Mutual Fund Trust” Status

- A “unit trust” is defined in subsection 108(2) of the ITA
 - 95% of the units of the trust (based on FMV) satisfy the “*redeemable on demand*” requirement (*the “108(2)(a) requirement”*); **or**
 - The trust satisfies certain underlying property ownership and diversification requirements (*the “108(2)(b) requirement”*)
- “*Redeemable on demand*” test
 - Temporal requirements are not expressly set out in the ITA
 - Market practice has established a range of broadly accepted bounds
 - Express CRA statements are older and provide limited guidance for non-prospectus funds

MFT Qualification Requirements: A Primer

“Mutual Fund Trust” Status

- The relevant “prescribed conditions” are principally set out in Regulation 4801
 - “Lawful distribution...to the public of units” / a class of units of the trust is “qualified for distribution to the public”
 - **In respect of a class of units of the trust**, there are at least 150 beneficiaries of the trust, each of whom holds:
 - not less than one “block of units” of the class; and
 - units of the class having an aggregate fair market value of not less than \$500

MFT Qualification Requirements: A Primer

“Mutual Fund Trust” Status

- “block of units” – *Regulation 4803(1)*
 - (a) 100 units, if the fair market value of one unit of the class is less than \$25,
 - (b) 25 units, if the fair market value of one unit of the class is \$25 or more but less than \$100, and
 - (c) 10 units, if the fair market value of one unit of the class is \$100 or more

MFT Qualification Requirements: A Primer

Retroactive Qualification Test – ITA 132(6.1)

“Where a trust becomes a mutual fund trust at any particular time before the 91st day after the end of its first taxation year, and the trust so elects in its return of income for that year, the trust is deemed to have been a mutual fund trust from the beginning of that year until the particular time.”

- Grants a newly-formed trust time to satisfy the “mutual fund trust” qualification requirements over a grace period and thereafter elect to have been a “mutual fund trust” from its inception
- For example, if a trust was formed in 2019, it has until March 30, 2020 to satisfy the “mutual fund trust” qualification requirements and can thereafter elect to have been a “mutual fund trust” from the date of its establishment

MFT Qualification Requirements: A Primer

Non-Resident Beneficiary Limitation – ITA 132(7)

- Where, at any time, it can reasonably be considered that a trust, having regard to all of the circumstances, was established or maintained primarily for the benefit of non-residents, the trust is deemed not to be a “mutual fund trust” after that time unless, generally, all or substantially all of its property consisted of property other than most types of “taxable Canadian property”
- The test has ongoing application throughout the life of a trust
- If the limitation is violated, the trust **cannot** regain its status as a “mutual fund trust” at a later date

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Confirming / Bringing Funds Back into Compliance

Confirming Compliance

Confirm “block of unit” Determinations

- Have unit valuations or the number of unitholders changed such that the “block of units” test is no longer satisfied?
- Will a subdivision or consolidation of units address the problem?
- Would a redesignation of units into a common class address the problem?
 - Be mindful of the \$500 FMV minimum
 - Does the Trust Agreement permit such action unilaterally?
 - If not, can the Trust Agreement be amended without unitholder notification or approval?

Confirming Compliance

Confirm Requisite Number of Unitholders

- Does the trust continue to have at least 150 qualifying unitholders in respect of a single class of units?
 - *Tip: Confirm that you have properly characterized what constitutes a “class” of units*
- Would a redesignation of units into a common class address the issue?
- If there are nominally fewer than 150 qualifying unitholders in respect of a single class of units of the trust, can the trust rely on the group aggregation deeming rules in the Regulations?
 - A “group of persons” that holds a “block of units” with the requisite FMV will be deemed to be one person for the purposes of determining whether the 150 unitholder test is satisfied – *Regulation 4803(3)*

Confirming Compliance

Confirm Requisite Number of Unitholders

- Regulation 4803(4) provides certain deeming rules for determining what constitutes a “group of persons”
 - *No person can be included in more than one group*
 - *No person can be included in a group if they stand as a qualifying unitholder on his/her own (i.e., they alone hold a “block of units” with the requisite FMV)*
 - *The membership of each group will be determined in the manner that results in the greatest possible number of groups*

Confirming Compliance

Do redemption limits / “gates” cause units to cease to be “redeemable on demand”?

- No bright line statutory/regulatory tests for income tax purposes
 - No jurisprudence or definitive CRA statements

Suspending Redemptions

Public Funds	Private Funds
<ul style="list-style-type: none">▪ Primarily governed by National Instrument 81-102▪ Also governed by constating documents / offering documents▪ Can only suspend in limited circumstances (s. 10.6 of National Instrument 81-102)▪ Can also apply for approval from securities regulators	<ul style="list-style-type: none">▪ Primarily governed by constating documents / offering documents▪ Applicable provisions are fund specific▪ Wide variance among funds

Suspending Redemptions – Private Funds

Applicable exchange(s) have suspended normal trading

Unable or impractical to accurately value assets and/or calculate NAV

For any reason for investor/fund protection at the discretion of the manager / GP / etc.

Suspension of redemptions of underlying fund(s)

Insufficient liquid assets or impractical to liquidate the assets of the fund

Suspending Redemptions – Considerations

- Notice
 - Specific provisions
 - General provisions
 - Standard of care / fiduciary obligations
- Differences between funds in the same fund family
- Fund of fund / feeder fund structures
- Equality for investors

Suspending Redemptions – Considerations

- Documenting analysis
- Potential conflicts
- Payment of redemption proceeds
 - Payout provisions
 - In-kind redemption proceeds
- Other non-legal considerations (e.g., investor relations, past practice)

Adding Redemption Provisions to Existing Funds

- Will depend on provisions of the fund's constating documents and offering documents
- Most likely cannot make changes without investor approval

Bringing Funds Back into Compliance

Temporary Retroactive Requalification – *ITA 132(6.2)*

- A trust that ceases to be a “mutual fund trust” in a particular year may be deemed to have been a “mutual fund trust” throughout the year if certain statutory tests are satisfied
- Statutory test requirements:
 - a) “Mutual fund trust” status lost for reasons other than the trust (i) ceasing to be resident in Canada, (ii) conducting activities other than investing its funds in property or undertaking certain permitted activities in respect of real property, or (iii) running afoul of the non-resident beneficiary restriction
 - b) The trust was a “mutual fund trust” at the beginning of the relevant year

Bringing Funds Back into Compliance

Temporary Retroactive Requalification – ITA 132(6.2)

- c) The trust would have been a “mutual fund trust” throughout the year if the reason for the trust ceasing to be a mutual fund trust was because (i) it ceased to satisfy the “108(2)(a) requirement”, and/or (ii) it ceased to satisfy the “prescribed conditions”
- Subsection 132(6.2) of the ITA effectively allows trusts that fall offside certain of the “mutual fund trust” qualification requirements to get back onside prior to the end of the year without suffering adverse characterization consequences

Imminent Non-Qualification

What can a trust do if it believes that it will imminently cease to be a “mutual fund trust”?

- Request “registered investment” status – *ITA 204.4*
 - A “mutual fund trust” can apply to the CRA to be a “registered investment” – *ITA 204.4(2)(c)*
 - Request is made by submitting CRA Form T2217
 - A unit of a trust is a “qualified investment” at a particular time if the trust was a registered investment “during the calendar year in which the particular time occurs or the immediately preceding year” – *Regulation 4900(1)(a)*
 - Alternatively, if the trust is not a “mutual fund trust” at the time of application, consider whether the trust might qualify as a “quasi-mutual fund trust” – *ITA 204.4(2)(d)*

Imminent Non-Qualification

What can a trust do if it believes that it will imminently cease to be a “mutual fund trust”?

- A “quasi-mutual fund trust” is effectively a trust that (i) would be “mutual fund trust” if it was able to satisfy the “prescribed conditions”, and (ii) only holds “qualified investments”
- If a trust becomes a “registered investment” on the basis of being a quasi-mutual fund trust, regard must be have to the special taxes that are payable by the trust if it ceases to solely hold “qualified investments” – *ITA 204.6(1)*
 - The trustee is potentially liable for the special tax – *ITA 204.7(2)*
- Advantages, disadvantages and limitations of a trust being a “registered investment”

Imminent Non-Qualification

What can a trust do if it believes that it will imminently cease to be a “mutual fund trust”?

- Consider a possible tax-deferred merger with another “mutual fund trust” – *ITA 132.2*
 - There are significant tax, securities, cost and timing considerations associated with a merger of mutual fund trusts; therefore, the decision to pursue a merger must be carefully analyzed

Implications of Ceasing to be a Mutual Fund Trust

Income and Penalty Taxes for Registered Plans

- Penalty tax for holding a “non-qualified investment” – *ITA 207.04*
 - Tax equals 50% of the FMV of the “non-qualified investment (at the time the prohibited holding commenced)” – *ITA 207.04(2)/207.01(6)*
 - Tax is payable by the “controlling individual” of the Registered Plan
- Tax on income from a “non-qualified investment” – *ITA 146(10.1)/ 146.2(6)/146.3(9)*
 - Tax is payable by the trust
 - 100% of capital gains are required to be included in the income of the trust for the purposes of computing the quantum of the tax payable

Implications of Ceasing to be a Mutual Fund Trust

Waiver of Penalty Taxes

- A taxpayer can request a waiver/cancellation of the penalty tax under certain circumstances – *ITA 207.06(2)*
 - CRA **may** waive/cancel the penalty tax where it considers it just and equitable to do so having regard to all the circumstances, including:
 - a) whether the tax arose as a consequence of reasonable error,
 - b) the extent to which the transaction or series of transactions that gave rise to the tax also gave rise to another tax under the ITA, and
 - c) the extent to which payments have been made from the taxpayer's registered plan

Implications of Ceasing to be a Mutual Fund Trust

Refund of Penalty Taxes

- Where a waiver/cancellation of the penalty tax is not available, the taxpayer can seek a refund of the penalty tax on the disposition of the “non-qualified investment” – *ITA 207.04(4)*
- A refund of the penalty tax is not available if:
 - a) it is reasonable to consider that the “controlling individual” knew, or ought to have known, at the time the “non-qualified investment” was acquired by the registered plan, that it was, or would become, a “non-qualified investment”, or
 - b) the “non-qualified investment” is not disposed of by the registered plan before the end of the calendar year following the calendar year in which the tax arose or any later time that the CRA considers reasonable in the circumstances

Implications of Ceasing to be a Mutual Fund Trust

Refund of Penalty Taxes

- To obtain a refund of the penalty tax, a return will need to be filed in respect of the penalty tax (*CRA Form RC339*), and interest may apply in respect of any period during which the penalty tax remained outstanding

Implications of Ceasing to be a Mutual Fund Trust

Notification Obligations

- Specific notice requirements
- General notice requirements
- Standard of care / fiduciary obligations
- Public funds governed by public disclosure requirements
 - Press release
 - MCR
- Other non-legal considerations (e.g., investor relations, past practice)
- Updates to offering documents

Implications of Ceasing to be a Mutual Fund Trust

Potential Causes of Action

- Statutory
- Contractual
- Breach of duty of care
- Regulatory scrutiny



“Prohibited Investment” Issues

Prohibited Investment Trap

Redemptions causing existing investors to have “significant interests” in a trust

- A unit of a trust is a “prohibited investment” for a registered plan if the “controlling individual” has a “significant interest” in the trust
- An individual has a “significant interest” in a trust if the individual, together with persons with whom the individual does not deal at arm’s length, holds interests in the trust that have a fair market value of 10% or more of the fair market value of the interests of all beneficiaries under the trust
- “Prohibited investments” do not include “excluded property”
 - “Excluded property” exception may be available if certain statutory criteria are satisfied (*trust is a mutual fund trust/registered investment, the trust is in its first/last 24 months of existence*)

Prohibited Investment Trap

Redemptions causing existing investors to have “significant interests” in a trust

- Rapid ameliorative steps, including the potential claim of a penalty tax waiver, could reduce/eliminate the adverse tax implications of a unitholder of the trust suddenly holding a “prohibited investment”



Partnerships and "Carried Interests"

Partnerships and “Carried Interests”

“Carried interests” dependent on the partnership earning income

- Consider implications of COVID-19-induced volatility on the allocation of income of the partnership
- Ensure that income/loss allocations, and distributions, are administered in accordance with the terms of the applicable limited partnership agreement

Questions?



Legal Note

The foregoing commentary is summary in nature and does not address all of the issues and considerations that may be relevant under any particular set of circumstances.

The statements and material presented herein do not represent legal or tax advice.

No arrangements should be executed on the basis of the foregoing statements and commentary.

Formal legal, tax, and accounting advice should be obtained prior to executing any transaction.

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