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Relief from LRE rules for trusts

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On October 20, 2014, the Department of Finance released long-awaited draft legislation (the Proposals) to provide some relief from the loss restriction event (LRE) rules as they apply to trusts. The government proposes a broad-based exemption for investment funds rather than a collection of piecemeal solutions to specific situations (e.g., exchange traded funds, fund-of-funds, start-up and wind-down scenarios) as was originally anticipated. The investment funds industry should welcome these Proposals because the broad-based exemption is effectively the type of relief it had sought in the first place. There is also relief from some of the administrative and compliance burdens that would otherwise follow from an LRE for a trust, for any situations not covered by the investment funds exemption.

The LRE rules were enacted with effect as of March 21, 2013. If one person or a group of persons acting in concert were to become the owner of a majority of the units of a trust (majority-interest beneficiary), taking into account units held by affiliated persons, the trust would be "subject to a loss restriction event". The taxation year of the trust will be deemed to end immediately before the LRE. The loss restriction rules that apply following the acquisition of control of a corporation will apply to the trust. All unrealized capital losses of the trust will be deemed to be realized and those losses as well as any losses (both capital and non-capital) carried forward from previous taxation years would generally be extinguished (including any "suspended losses" from prior years). An election can be made to crystallize any unrealized capital gains and step up the adjusted cost base of capital properties, in an effort to mitigate or overcome the loss restriction rules.

The LRE rules for trusts were intended to address a perceived gap in the law, as commercial trusts could be used to carry on business (e.g., income trusts). Yet there was no provision that would deter "trading" in loss trusts, in the same way that the acquisition of control provisions and other rules are aimed at trading in shares of corporations with losses. The LRE rules were drafted so broadly that they applied to retail mutual funds, pooled funds, exchange traded funds and other similar collective investment vehicles. The investment funds industry believed that the LRE rules went well beyond the abuse that was targeted and that, as a policy matter, they should not apply to funds. The LRE rules also created a host of administrative and compliance issues for fund managers including the inability to know on a timely basis of the occurrence of an LRE, the challenge of making sufficient distributions on or before the date of the LRE and the prospect of multiple filings of tax returns and information slips, to name a few.

“Investment funds” not subject to the LRE rules

The Proposals introduce the concept of an “investment fund”. If a person or group of persons acting in concert were to become a majority-interest beneficiary of an investment fund through the acquisition of units of the fund, the investment fund would not generally be subject to an LRE. The person or group of persons would be deemed not to have become a majority-interest beneficiary or majority-interest group of beneficiaries, respectively. The one caveat is that the acquisition of units of the trust must not be part of a series of transactions or events that includes the particular trust “becoming a portfolio investment fund” or “ceasing to be an investment fund”. We note that a person or group of persons could become a majority-interest beneficiary of a trust as a result of another person or persons redeeming units of the trust. In this case, the person or group of persons would not become a majority-interest beneficiary by virtue of acquiring units of the trust and thus the LRE rules may still technically apply. It may be necessary to consider that the trust acquires the units that were redeemed by the other person or persons.

There are two principal conditions that a trust must meet to be an investment fund and thereby qualify for an exemption from the LRE rules: one condition relates to the status of the trust for tax purposes and the other condition relates to the assets owned by the trust.

Tax status of a trust

In order to be an investment fund, a trust must qualify as either of the following two types of trusts throughout the period from the later of March 21, 2013 and the date of formation of the trust to the date that the LRE would otherwise occur:

- A mutual fund trust, or,
- A trust that would qualify as a mutual fund trust if it were not for the fact that it did not have the minimum number of unitholders (i.e., 150). Such a trust is commonly referred to as a “quasi-mutual fund trust”. All beneficiaries that are entitled to distributions from the trust must have “fixed interests” in the trust.

  A fixed interest in a trust is one for which the amount of the distributions to a particular beneficiary is either (a) not dependent upon the exercise of a discretionary power or (b) based upon a discretionary power that is consistent with normal commercial practice, is arm’s length in nature and will not materially affect the value of a person’s interest in the trust relative to other beneficiaries.

Assets owned by the trust

The mutual fund trust or quasi-mutual fund trust having units that are fixed interests, as the case may be, must not own any of the following types of property (non-portfolio property) at the time of the LRE:

- Securities of an entity (e.g., debt securities, shares of a corporation, units of a trust or partnership) that have a fair market value that exceeds 10% of the fair market value of all the equity interests in that entity. Units of another trust would not be a non-portfolio property if that other trust does not own any non-portfolio property. Therefore, the Proposals should bring most fund-of-fund structures outside the scope of the LRE rules;
- Real property or resource properties the total fair market value of which exceeds 50% of the value of the units of the trust. This particular category of property may mean that REITs do not qualify for an exemption from the LRE rules; or
- Assets used in the course of carrying on a business of the trust.

Provided that these asset restrictions are complied with and a trust is either a mutual fund trust or a quasi-mutual fund trust as described above, the trust should be an investment fund and should be exempted from the LRE rules.

Administrative relief for any LREs

If there are still some trusts that may be subject to an LRE, the Proposals provide some relief from the compliance burdens that would otherwise follow from a deemed year-end. The LRE is not considered to result in a deemed year-end in respect of:

- The due date for filing T3 trust returns and providing T3 slips to the unitholders;
- The due date for the payment of any tax liability; and
- The provision that allows a start-up fund to elect to be treated as a mutual fund trust retroactive to the date of formation of the fund. The fund must obtain the minimum number of unitholders within 90 days of the end of the fund's first taxation year to qualify for this election. An LRE will not shorten this time period.

Some filing obligations may not be afforded relief by the Proposals (e.g., the information return for funds that are registered as registered investments). We further understand that while the due date for filing the return for a taxation year which is deemed to end on an LRE is extended, it will still be necessary to prepare two or more returns for the same twelve-month period (i.e., one for each LRE deemed year-end that occurs in the period that ends on either December 15 or 31 (the normal year-end of the fund) plus the return for the period that would end on that day).

Effective date for the relieving measures

These new rules will be deemed to come into force on March 21, 2013 unless the trust elects on or before the trust's filing due date for its last taxation year that ends before January 1, 2015, in which case the rules are deemed to come into force on January 1, 2014.

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