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Canadian tax alert

2017 federal budget - impact on financial institutions

March 31, 2017

This tax alert analyzes the proposals in the 2017 budget that we believe will be of interest to financial institutions and, in some cases, their clients:

- Anti-avoidance rules that will apply to offshore branches of multinational life insurers;
- The tax-deferred reorganization of an entire multi-class mutual fund corporation into individual mutual fund trusts that correspond to the funds within the corporation;
- A new elective regime to apply mark-to-market accounting for derivatives on income account; and
- An anti-avoidance rule aimed at tax-motivated straddle transactions.

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For a summary of all of the tax changes in the budget, we invite you to review Deloitte's 2017-2018 federal budget highlights.

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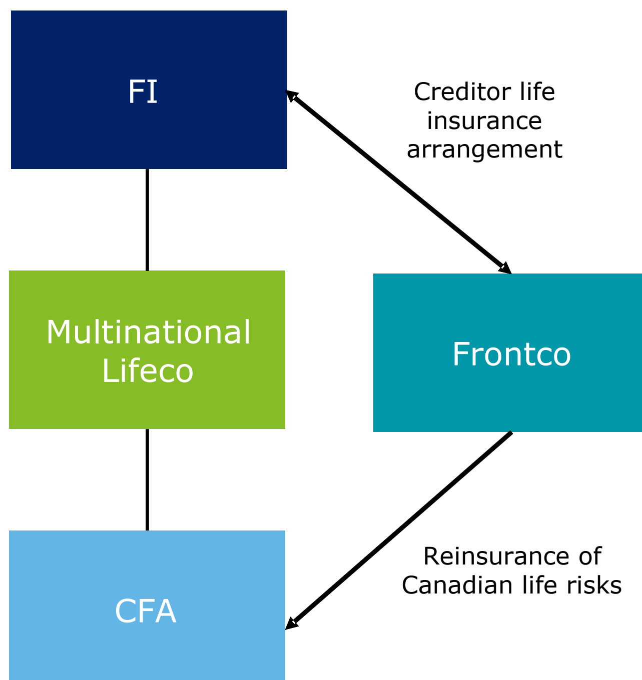
Foreign branches of multinational life insurers

Canadian resident multinational life insurance companies are taxed on a territorial basis. That is, only the income from the life insurance business that is carried on in Canada is subject to tax in Canada. Investment income earned by the multinational life insurer is allocated to the Canadian tax base using a formulaic approach. These resident insurers are generally the only non-exempt taxpayers that are not subject to tax on their worldwide income.

As a result of this tax treatment, income from life insurance that is earned from a business that is carried on in a foreign branch is not subject to tax in Canada. Contrary to the foreign affiliate regime where certain criteria must be met in order for insurance income to be considered active business income, the foreign branch life insurance exemption does not contain such criteria. More specifically, the foreign accrual property income (FAPI) rules dealing with the insurance of Canadian risks in a foreign affiliate don't have a similar rule in the context of the multinational insurance rules. For example, the FAPI rules will generally apply to deem the insurance of Canadian risks in a controlled foreign affiliate (CFA) to be taxable in Canada on a current basis.

In example 1, the reinsurance of Canadian life risks into the CFA would generally be taxable as FAPI.

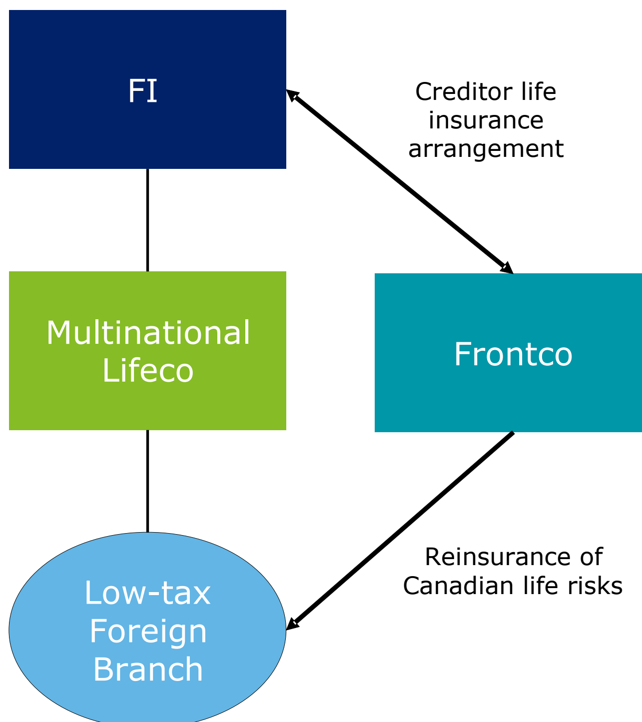
Example 1



Rules were introduced in the 2014 and 2015 budgets to prevent the CFA from converting what would otherwise be income from the insurance of Canadian life risks taxable as FAPI into income from the insurance of foreign risks. This was generally achieved through the use of swap arrangements.

Following the introduction of these anti-avoidance rules, certain taxpayers saw the multinational life insurance exemption rules as another means of achieving the same tax result that was possible prior to the 2014 and 2015 budget changes, as shown in example 2.

Example 2



In this example, if the low-tax foreign jurisdiction branch contracted with Frontco to reinsure the Canadian life risks that it had underwritten under the creditor-life arrangement, the underwriting profits from that business would not be taxable in Canada due to the territorial regime available to resident multinational life insurers.

The 2017 budget proposes to make the existing avoidance rules that apply to foreign affiliates applicable to foreign branches of Canadian life insurance companies thereby causing the offshore earnings to be taxable in Canada. The budget will also expand the anti-avoidance rules to deem certain arrangements to result in a foreign affiliate or foreign branch to be insuring Canadian risk such that FAPI or Canadian income tax will apply to the offshore earnings.

Reorganization of multi-class mutual fund corporations

Background

A multi-class mutual fund corporation is a relatively common investment fund structure in the Canadian marketplace. Each class of shares of the corporation tracks the value of a particular asset class or investment strategy and is treated

as a separate fund for regulatory purposes. All of the funds contributed to the corporation by persons who subscribe for shares of a particular class are invested in accordance with the investment objectives of the fund to which that class relates. For example, the portfolio manager for a "Canadian equity class" would invest in a portfolio of Canadian equities or in a mutual fund trust (underlying fund) that invests in Canadian equities. A "fund-of-fund" multi-class corporate structure is fairly common in the industry. Many of the funds within a multi-class corporation mirror the investment strategies of a separate mutual fund trust that is managed by a fund manager. The corporate class fund may own units of the particular underlying fund rather than invest directly in the same assets as the underlying fund.

One of the principal tax benefits of this investment fund structure was that an investor could exchange shares of one class of a corporation (e.g., Canadian equity class) for shares of another class (e.g., US equity class) on a tax-deferred basis. Such a change in investments by an investor could not be done on a tax-deferred basis if the investor were to redeem units of a Canadian equity mutual fund trust (or sell Canadian equities owned directly) in order to fund the purchase of units of a US equity mutual fund trust (or purchase US equities). Such tax-deferred switching was shut down by the 2016 federal budget, effective for exchanges of shares of a mutual fund corporation made on or after January 1, 2017.

2017 budget proposal

Section 132.2 of the Income Tax Act (the Act)[1] provides for a tax-deferred conversion of a mutual fund corporation into a single mutual fund trust and the merger of a mutual fund trust with another mutual fund trust, where the conversion or merger is a "qualifying exchange".

The 2017 budget provides for a one-time, tax-deferred conversion of an entire multi-class mutual fund corporation into one or more individual mutual fund trusts. This proposal is the direct result of submissions made to the Department of Finance by the industry in response to the 2016 budget amendment. A number of investment fund managers had decided that in the absence of tax-deferred switching at the investor level, they did not want to retain their multi-class mutual fund corporation. But some managers were only prepared to wind up the structure if they could do so on a tax-deferred basis for their investors. Other fund managers who had not yet reached a similar conclusion regarding their corporate class fund wanted the flexibility to carry out a tax-deferred reorganization in the future, should they change their mind. The industry was able to convince the Department of Finance of the policy merits of such a tax-deferred reorganization, including why it was consistent with the object and spirit of section 132.2.

The industry had also sought an amendment to section 132.2 to allow the merger of individual classes or funds within a mutual fund corporation with individual mutual fund trusts, while retaining the rest of the funds within the corporate class structure (i.e., "partial class to fund mergers"). A partial merger would be undertaken to remove tax-inefficient or small and unprofitable funds from the corporate class structure. The Department of Finance was not amendable to this proposal.

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[1] All statutory references in this alert are to the Income Tax Act (the Act) unless otherwise noted.

Proposed amendments to section 132.2
The definition of "qualifying exchange" in subsection 132.2(1) will be amended so that a multi-class mutual fund corporation can effectively be wound up on a tax-deferred basis for both the shareholders and the fund. We will describe this amendment in the context of a mutual fund corporation that is comprised of 20 separate funds and classes of shares. The principal conditions that must be satisfied in respect of this particular type of reorganization are as follows:

- All or substantially all of the property of the multi-class mutual fund corporation must be transferred to two or more mutual fund trusts (20 trusts in our example) as of a particular time ("the transfer time");
- Where a class of shares of the corporation is recognized under securities law as an "investment fund", the holders of those shares must receive, in return for their shares, units of a mutual fund trust that received all or substantially all of the assets allocated to that transferor investment fund immediately before the transfer time; and
- The shareholders of the mutual fund corporation must have their shares redeemed within 60 days after the transfer time.

Effectively this means that the assets of all 20 funds within the corporation should be transferred to 20 separate mutual fund trusts at (or about) the same time. It is important to know when the transfer time occurs, as many of the consequences of a qualifying exchange are measured by reference to the transfer time. Furthermore, the property attributable to each of the 20 separate classes of shares should be transferred to the corresponding trust, the units of which will be transferred to the shareholders of the particular class. For example, the property of the Canadian equity class should be transferred to the Canadian equity mutual fund trust. A transferee trust can be an existing mutual fund trust or a newly formed trust that will qualify as a mutual fund trust by the filing due date of its first tax return. The rest of the amendments to section 132.2 address the fact that there may be more than one transferee trust.

The normal consequences of structuring a merger of funds as a qualifying exchange will apply to such a reorganization of a multi-class mutual fund corporation, including the following:

- Deemed year-end for the funds participating in the reorganization;
- Extinguishment of all loss carryforwards of the funds, unless the losses can be used against realized and unrealized gains for the year of the reorganization; and
- Tax-deferred exchange by the shareholders of shares of a class of the corporation for units of the corresponding mutual fund trust.

The above amendments are effective for transfers that occur on or after March 22, 2017.

Technical issues and planning considerations
There are a number of technical issues and planning matters that should be considered before embarking upon the conversion of a multi-class mutual fund corporation into individual mutual fund trusts. They include:

- Structuring the timing of the various corporate law matters so that all funds within the structure can be "converted" into trusts at the same time. The current definition of qualifying exchange only contemplates a single fund converting into or merging with a single fund at a particular

time. The budget proposal does not include any amendments to assist with a more complicated conversion of multiple classes or funds, such as by expanding the meaning of "transfer time" to be a specified period of time;
- Determining how to structure the conversion of a fund-of-fund corporate class fund so that it constitutes a qualifying exchange;
- Ensuring that any transferee trust is or will be a mutual fund trust when the shareholders of the relevant class of the mutual fund corporation are taken into account. If there are any funds within the structure that will not qualify as mutual fund trusts or for some other reason will not be converted, they should be removed from the structure before the reorganization; and
- Considering alternatives for optimizing the "capital gains refund mechanism" and ensuring that all refundable taxes are recovered, given the fact that the corporation will lose its status as a mutual fund corporation shortly after it transfers its assets to the transferee trusts.

In addition to the foregoing, each investment fund manager should assess the pros and cons of maintaining their particular multi-class mutual fund corporation. There are still a number of tax attributes or advantages of such funds above and beyond tax-deferred switching. However, the nature and extent of those tax benefits will depend upon the particular facts, including the mix of assets or funds within the structure, the fee structure of the classes and whether it is a fund-of-fund structure.

Corporate fund class-to-class mergers
Prior to the 2016 budget, it was possible to merge two or more classes of shares or funds within a multi-class mutual fund corporation on a tax-deferred basis. One would rely upon either section 51 or section 86 of the Act. The 2016 budget amendment to shut down tax-deferred switching, subsection 131(4.1), effectively eliminated such tax-deferred mergers effective January 1, 2017. Therefore, it is possible to merge two mutual fund trusts having similar investment mandates on a tax-deferred basis under section 132.2, but similar corporate fund class-to-class mergers are not tax-deferred. The 2017 budget did not include an amendment to subsection 131(4.1) to allow for such tax-deferred mergers.

Mark-to-market election and a new realization default rule for derivatives

The 2017 budget introduces a new mark-to-market election that is principally found in proposed section 10.1. This rule affects the computation of income from a business or property and is the government's second response to the *Kruger* decisions. In 2015, the Tax Court of Canada released a decision that indicated derivatives could be carried at the lesser of cost or market in accordance with the inventory rules. The government overruled this decision in the 2016 budget through changes to subsection 10(15) and paragraph 18(1)(x) of the Act, preventing the lower of cost or market accounting for derivatives. The current budget proposal responds to the Federal Court of Appeal decision in *Kruger* that held derivatives were not normally inventory to which lower of cost or market accounting could apply, but that derivatives could be accounted for using fair value or mark-to-market accounting.

Eligible derivatives
The budget proposal applies to "eligible derivatives" which include "agreements" that are swap agreements, forward purchase or sale agreements, forward rate agreements, futures agreements, option agreements or similar agreements. This portion of the definition is similar to the types of derivatives that were deemed not to be inventory by the 2016 budget legislation. The agreements will also be required to meet three additional conditions to be eligible derivatives:

- An agreement cannot be a capital property or obligation on capital account, or a Canadian or foreign resource property;
- The taxpayer must have either produced audited generally accepted accounting principles (GAAP) financial statements for the year in question, or the agreement must have a readily ascertainable value; and
- If the taxpayer is a financial institution as defined in subsection 142.2(1) of the Act, the agreement cannot not be otherwise subject to the tracking property rules.

This definition should apply to most simple derivatives that are not on account of capital and not otherwise required to be marked to market. However, items accounted for as "embedded derivatives" which are not separate contracts but are rights or obligations that are included in a separate contract that is not itself a derivative are not addressed.

Elective use of mark-to-market accounting
If a taxpayer - including a financial institution as defined in subsection 142.2(1) - holds an eligible derivative, it can elect to treat the derivative on a mark-to-market basis for a particular taxation year and all subsequent taxation years by filing an election under subsection 10.1(1)on or before its filing due date for that year. The election cannot be revoked without the consent of the Minister of National Revenue.

Alternatively, if the taxpayer does not elect to use mark-to-market accounting, subsection 10.1(7) provides that a taxpayer that is not a financial institution cannot use mark-to-market accounting in respect of the types of agreements that may be eligible derivatives. As mentioned, subsection 10(15) and paragraph 18(1)(x) prevent a taxpayer from applying the lower of cost or market rules in computing income for any derivatives that may be considered to be inventory. This restriction, taken together with subsection 10.1(7), effectively requires taxpayers to use realization accounting for most derivatives on income account. Therefore, the Federal Court of Appeal decision in *Kruger*, which indicated that at least some taxpayers could use fair value accounting in accordance with section 9, is overridden.

One consequence of a taxpayer's electing to use mark-to-market accounting is that it may be easier to achieve an effective tax hedge. For example, a taxpayer that has foreign currency accounts payable may choose to hedge its exposure by buying forward foreign currency. If the taxpayer elects to use mark-to-market accounting, the payable may be carried at its spot currency value and the derivative is accounted for at fair market value, which will result in an effective tax hedge. If a taxpayer does not elect and the derivative is carried at cost, it will still be required to revalue the payable based on spot rates, but will not be able to mark the derivative to market.

Subsection 10.1(7) applies to the various types of derivative agreements that could be eligible derivatives whether or not they meet the three conditions of the definition. As a consequence, if a taxpayer holds a derivative that is not reflected in audited GAAP financial statements and that does not have a readily ascertainable value, the taxpayer will not be able to mark the derivative to market.

The effect of the mark-to-market election depends on whether the taxpayer is a financial institution. If the taxpayer is a financial institution, paragraph 10.1(3)(a) would deem the derivative agreement to be a mark-to-market property. Many derivatives held by a financial institution are already mark-to-market property as a result of the tracking property rules in subsection 142.2(1). The principal effect of paragraph 10.1(3)(a) will be to extend mark-to-market treatment to classes of derivatives that are not already covered by the definition of tracking property such as interest rate swaps. Many financial institutions already use mark-to-market treatment for such derivatives.

A non-financial institution that elects to have the new rules apply will be subject to subsection 10.1(5) which will result in annual mark-to-market treatment through a fair market value deemed disposition or settlement and reacquisition, reissuance or renewal of eligible derivatives.

Derivatives held at time of election, deeming rules and consequential amendments

Subsection 10.1(6) will apply to taxpayers that elect into the new mark-to-market regime but have not previously marked the affected agreements to market. Such taxpayers will be deemed to settle the derivatives at fair market value, but will not recognize the tax consequences (i.e., gain or loss) until the taxpayer actually “disposes” of the agreement. The stop loss rule in subsection 18(15) can apply in the actual year of disposition to any deferred loss that is deemed realized under section 10.1. Consistent with the Federal Court of Appeal decision in *Kruger*, subsection 10.1(6) assumes that taxpayers could otherwise have applied mark-to-market treatment to derivatives under section 9 prior to the introduction of subsection 10.1(7).

Subsection 10.1(8) is a deeming rule that addresses interpretational issues in the application of subsections 10.1(5) and (6). If a particular derivative is not property, as in the case of a written option, the taxpayer is deemed to “hold” an eligible derivative while it is a party to the agreement. The settlement or extinguishment of a derivative that is not property is deemed to be a disposition. These interpretational rules clarify that derivatives that are liabilities at a point in time are treated the same as derivatives that are property.

The proposal includes a number of amendments to the Act’s reorganization provisions. Subsection 18(15) is amended so that the stop loss rule will not apply to eligible derivatives. Sections 85 and 97 have been changed so that eligible derivatives that are accounted for on a mark-to-market basis will be ineligible for a tax deferred rollover; this rule will prevent taxpayers from deferring income through a transfer between a party that has elected to carry a derivative at fair market value and a transferee that has not so elected. Sections 87 and 88 are amended to ensure continuity of treatment of eligible derivatives after an amalgamation or tax deferred wind up.

All of the above-mentioned amendments will apply for taxation years that begin on or after March 22, 2017.

Straddle transactions

The second proposed timing rule is an anti-avoidance provision that denies tax benefits in respect of so-called straddle transactions under which a taxpayer is both long and short in respect of the same underlying property or liability. A taxpayer that has an offsetting gain and loss can obtain a timing benefit by settling the losing leg of the transaction in one year and deferring recognition of the offsetting gain leg until the next year. If the taxpayer is taxed at a lower rate in the subsequent year, or can avoid being taxed on the winning leg, the timing difference becomes a permanent benefit. As a practical matter, taxpayers who use mark-to-market accounting in respect of the relevant assets and liabilities cannot obtain a tax benefit from straddle transactions. Moreover, the rules should not apply if other rules such as the stop loss or synthetic disposition rules otherwise eliminate the tax benefit of a transaction.

Offsetting positions and positions – the tax definition of straddle

The proposed rules are directed at transactions described in the definition of "offsetting position" in subsection 18(17), which in turn refers to the defined term "position". The term offsetting position includes arrangements under which a taxpayer, alone or in combination with non-arm's length or connected persons or partnerships, holds one or more positions that have the effect of eliminating all or substantially all of the holder's risk of loss or opportunity for gain in respect of another position or positions. The risk of loss test is supplemented by an anti-avoidance rule in paragraph 18(21)(c) that deems a position to be an offsetting position if there is a high degree of negative correlation between that position and another position and it can reasonably be considered that the principal purpose of the transactions in question is to avoid, reduce or defer tax that would otherwise be payable under the Act. This new anti-avoidance rule will be particularly relevant to straddle transactions involving options which typically eliminate the risk of loss or the opportunity for gain, but not both as required by the definition of offsetting position.

The scope of the definition of offsetting position is limited by including a purpose test that applies if relevant positions are held by two or more connected persons and excluding positions that are not held for the purpose of offsetting the holder's risk of loss or opportunity for gain. The purpose test ensures that large groups of affiliated persons are not inadvertently subjected to the new rules if they happen to hold two positions that are mutually offsetting. It is important to note, however, that an offsetting position does not have to comprise two positions that are of the same type. For example, a taxpayer could be subject to the proposed rules if the taxpayer held a security and a derivative that offset the risk associated with holding the security.

The term position in subsection 18(17) describes various assets and liabilities of a taxpayer in respect of which it can enter into or create an offsetting position. For an asset or liability to be a position, it must satisfy a two-pronged test. The first prong describes one or more properties, obligations or liabilities that are:

- Shares of a corporation;
- Interests in partnerships;
- Interests in trusts;
- Commodities;

- Foreign currencies;
- Derivative agreements;
- Foreign currency debts, debts with contingent interest, or debts convertible into shares, partnership interests, trust interests or commodities;
- Obligations to transfer or return to a person property identical to one described in the preceding list that had been borrowed from that person; or
- Interests and rights in property that would otherwise meet the first prong of the definition.

The second prong of the definition applies if there is more than one property, obligation or liability. It must be reasonable to conclude that each is held in connection with the other. The effect of this second prong is to combine multiple assets and liabilities into a single position. However, as the proposal is currently drafted, an asset or liability that is not held in connection with another asset or liability to create an offsetting position is not subject to the second prong of the definition and would appear to constitute a position.

Loss deferral rules
Subsection 18(18) makes subsection 18(19) apply every time there is a disposition by a taxpayer, referred to as a transferor, of a position unless:

- The disposition is a deemed disposition under section 70, subsection 104(4), section 128.1 or subsections 138(11.3) or 149(1);
- The transferor is a financial institution as defined in subsection 142.2(1) or a mutual fund trust or mutual fund corporation; or
- The position is a capital property, liability or obligation of the transferor.

Although subsection 18(19) appears under the title "straddle losses", it applies to the disposition of any position described in subsection 18(18). However, the computation rule in subsection 18(19) should not require a taxpayer to defer a loss in respect of the disposition or settlement of a position that is not part of an offsetting position.

The mechanics of the computation rule in subsection 18(19) are complex. The provision will apply to all dispositions of positions – a very small proportion of which will be offsetting positions or straddle transactions to which the new rules are directed. However, subsection 18(19) will not override the amount of income or loss a taxpayer would normally recognize on the disposition of an asset or settlement of a liability unless a number of conditions are present.

Subsection 18(19) limits a taxpayer's loss on the disposition of a position in the year to the amount determined by the formula A + B – C, where:

- A includes the amount of losses otherwise realized in the year of disposition, subject to the stop loss rule in subsection 18(15) the application of which will eliminate the tax benefit of a straddle transaction;
- B effectively includes losses realized on dispositions in previous years that are deferred in accordance with subsection 18(19); and
- C is the key provision: When it equals zero, subsection 18(19) will not reduce the amount of the taxpayer's loss on the disposition or settlement of a position.

The circumstances under which C will not equal zero can be present if a taxpayer has an "unrecognized profit" at the end of the year in respect of a position, an offsetting position, a "successor position" or a position that is an offsetting position in respect of a successor position. The terms unrecognized profit and successor provision are both defined in subsection 18(17).

An unrecognized profit refers to the profit that would be realized if the taxpayer disposed of its position at the end of the year for fair market value. The definition appears capable of applying only to positions or arrangements that comprise more than one asset or liability and not to single assets or liabilities that are not offset by another asset or liability.

To provide a simple illustration of the application of the definition of unrecognized profit, consider a taxpayer that starts a year with a position and an offsetting position that comprise a long and short derivative. If at year end the taxpayer settles the long derivative and realizes a loss of $5 but does not settle the short derivative which has an unrealized gain of $4, the unrecognized profit at year end on the position is $4. In a simple circumstance, formula element C will equal $4 and the taxpayer will only be able to claim $1 of its $5 loss at year end.

The definition of successor position is an avoidance rule inside the larger avoidance rule that prevents a taxpayer from settling one leg of an offsetting position and then immediately reestablishing that leg of the straddle. If a taxpayer enters into a new position that replaces an initial position that offsets a second position, the new position will be a successor position. However, consistent with the existing affiliated person stop loss rules, if the taxpayer settles its initial position and does not enter into a new offsetting position for thirty days, the new offsetting position is not a successor position. If a taxpayer holds a successor position with an unrealized gain at year end, formula element C can include the amount of the loss realized on the disposition of the second position that was part of the straddle relationship with the initial position.

Formula element C is reduced if the taxpayer forms a straddle relationship and one of the unrealized positions has an unrecognized loss as defined in subsection 18(17). The amount under formula element C is also reduced if the taxpayer realizes deferred losses on successor and offsetting positions. Finally, the rule contains provisions that are designed to avoid double counting of losses and double counting of gains that offset the amount of deferred losses.

Exceptions to the straddle rules and staggered year ends
Various taxpayers and activities will not be subject to the proposed straddle rules, as provided in proposed subsection 18(20):

- An exception is provided for hedging activities of taxpayers that enter into positions in respect of commodities manufactured, produced, grown, extracted or processed by the taxpayer. A hedging exception will also apply to activities to reduce exposure to interest rate and foreign currency fluctuations in respect of a taxpayer's debts, unless the taxpayer is in the business of holding offsetting positions in respect of debts.
- If a taxpayer enters into an offsetting position and closes out a losing position without entering into a new position that eliminates the risk associated with the winning position within 30 days, subsection 18(19)

will not apply. Thus, for example, if a taxpayer with a calendar year-end closes out one leg of a straddle on December 5 and holds onto the winning leg of straddle until January 10 of the following year, the taxpayer will be permitted to claim the loss realized on December 5.
- Subsection 18(19) will not apply if it can reasonably be considered that none of the main purposes of the series of transactions is to avoid, reduce or defer tax. Because the straddle rules are an anti-avoidance provision aimed at tax-motivated straddles, it is to be expected that this rule will provide a wide-ranging exception for transactions entered into purely for business reasons.

Three deeming rules that apply to the new straddle proposals are included in subsection 18(21):

- A rule similar to subsection 10.1(8) addresses interpretational issues with respect to derivatives and other provisions that are not technically property.
- A partial disposition of a position is deemed to be a disposition.
- As discussed above in respect of offsetting positions, a position that is negatively correlated with another position is deemed to be part of an offsetting position if entered into for purposes of tax avoidance.

Furthermore, anti-avoidance rules are provided in subsections 18(22) and (23) to deal with connected persons who together hold offsetting and successor positions but have different year ends. If a connected person and a taxpayer together hold offsetting positions, the taxpayer may be able to recognize a loss when the connected person recognizes a profit on the "gain position" of an offsetting position. For example, if the connected person's year end is December 31 and occurs after the taxpayer's year end of March 31, a tax deferral is effectively achieved if the taxpayer realizes a loss and the connected person realizes a gain in the first three calendar months of the year. Subsection 18(23) addresses this result by treating a portion of the gain as an unrecognized profit for the purpose of applying subsection 18(19). The portion of the gain treated as an unrecognized profit is based on a fraction equal to the number of days in the connected person's tax year that are after the end of the taxpayer's year end divided by the total number of days in the connected person's taxation year.

Can we assist?

The budget proposals are complex. If you have any questions or concerns about these rules, please contact your Deloitte representative or the individuals listed on this newsletter.

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