BY KEVIN WARK

Reversal of Fortune

How the proposed budget affects certain investments and charitable strategies

On March 22 Finance Minister Bill Morneau tabled budget 2016, which is framed as "Growing the Middle Class." The budget includes a number of proposed tax changes and three measures of specific interest to the advisory community are highlighted below. See page 24 for new tax rules governing corporate-owned life insurance.

CORPORATE CLASS MUTUAL FUNDS

Canadian mutual funds can be in the legal form of a trust or a corporation. While most funds are structured as mutual fund trusts, some are structured as mutual fund corporations.

Many of these mutual fund corporations offer different types of asset exposure in different funds, but each fund is structured as a separate class of shares within the mutual fund corporation. Investors are able to exchange shares of one class of the mutual fund corporation for shares of another class. By virtue of a general provision in the Act that applies to convertible corporate securities, this exchange is deemed not to be a disposition for income tax purposes. This deferral benefit that is available to taxable investors in these so-called switch funds is not available to taxpayers investing in mutual fund trusts or investing with their own account directly in securities.

Budget 2016 proposes to amend the Act so that an exchange of shares of a mutual fund corporation (or investment corporation) that results in the investor switching between funds will be considered for tax purposes to be a disposition at fair market value. The measure will not apply to switches where the shares received in exchange differ only in respect of management fees or expenses to be borne by investors and otherwise derive their value from the same portfolio or fund within the mutual fund corporation (e.g., the switch is between different series of shares within the same class). This measure will apply to dispositions of shares that occur after September 2016.

Finance Minister Bill Morneau

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INDEXED LINKED NOTES

An indexed linked note (a "linked note") is a debt obligation, most often issued by a financial institution, the return on which is linked in some manner to the performance of one or more reference assets or indices over the term of the obligation. The referenced asset or index — which can be a basket of stocks, a stock index, a commodity, a currency, or units of an investment fund — is generally unrelated to the operations or securities of the issuer.

The Act contains rules that deem interest to accrue on a prescribed debt obligation, which includes a typical linked note. These rules require an investor in a linked note to accrue the maximum amount of interest that could be payable on the note in respect of a given taxation year.

Investors generally take the position that there is no deemed accrual of interest on a linked note prior to the maximum amount of interest becoming determinable. Instead, the full amount of the return on the note is included in the investor's income in the taxation year when it becomes determinable, which is generally shortly before maturity.

A specific rule provides that interest accrued to the date of sale of a debt obligation is included in the income of the vendor for the year in which the sale occurs. However, some investors, who hold their linked notes as capital property, sell them prior to the determination date to, in effect, convert the return on the notes from ordinary income to capital gains, only 50 per cent of which is included in their income. These investors take the position that no amount in respect of the gain on a linked note is accrued interest on the date of sale of the note for the purposes of this specific rule.

On that basis, these investors include the full amount of the return on a linked note in the proceeds of disposition and claim the return on the note as a capital gain. To facilitate this planning, issuers of linked notes often establish a secondary market where investors can sell their linked notes prior to maturity to an affiliate of the issuer.

Budget 2016 proposes to amend the Act so that the return on a linked note retains the same character whether it is earned at maturity or reflected in a secondary market sale. Specifically, a deeming rule will apply for the purposes of the rule relating to accrued interest on sales of debt obligations. This deeming rule will treat any gain realized on the sale of a linked note as interest that accrued on the debt obligation for a period commencing before the time of the sale and ending at that time.

When a linked note is denominated in a foreign currency, foreign currency fluctuations will be ignored for the purposes of calculating this gain. An exception will also be provided where a portion of the return on a linked note is based on a fixed rate of interest. In that case, any portion of the gain that is reasonably attributable to market interest rate fluctuations will be excluded. This measure will apply to sales of linked notes that occur after September 2016.

CHARITABLE GIFTING MEASURES: A REVERSAL OF FORTUNE

In response to requests from registered charities, new rules were introduced in the 2008 federal budget that reduced the capital gain realized on the donation of certain securities (including shares in public corporations, units in a mutual fund trust, and an interest in a segregated fund policy) to nil. This effectively increased the value of the charitable donation by eliminating the tax liability arising from the disposition of the security.

Since the introduction of this measure the charitable sector has made ongoing representations to the government to expand the exemption from tax to the donation of private shares or real estate. However, Finance has resisted this change primarily due to valuation concerns — how would the charity or the CRA verify the appropriate amount to receipt for a gift that may be illiquid and/or whose value cannot be easily ascertained?

Last year's federal budget introduced a rather elegant solution to the valuation issue by exempting individual and corporate donors from tax on the sale of private shares or real estate to an arm's-length party, if the cash proceeds are donated within 30 days. If a portion of the cash proceeds is donated, the exemption from capital gains tax would apply to that portion. This measure was intended to apply to donations in respect of dispositions occurring after 2016. In July 2015 Finance released draft legislation to give effect to these proposals.

Budget 2016 provides a different answer. The government announced that it no longer intends to proceed with this measure. This is an unfortunate development for the charitable community and hopefully this decision will be reconsidered in a future budget. F

KEVIN WARK is the president of the Conference for Advanced Life Underwriting (CALU) and can be reached at kwark@calu.com. More information on these tax proposals is available at www.calu.com.