Chapter Six

Taxation of Mutual Funds

by Laura M. White**

Laura White is a partner with Borden Ladner Gervais in Toronto.

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This chapter describes the income taxation under the Income Tax Act (Canada) (the Act)[1] of a mutual fund, whether structured as a trust or a corporation.[2] This chapter also discusses the taxation of investors, but only in context of the flow-through nature of a mutual fund. The taxation of investors is not the focus of this chapter.

By way of background, the term 'mutual fund' does not have a meaning for tax purposes. Rather, the term is defined in securities legislation and widely used to describe an open-ended investment fund that is sold by simplified prospectus and governed by National Instrument 81-102 (NI 81-102). 'Open-ended' is not a technical term, but is used to refer to an investment fund whose units are redeemable on demand of the holder. 'Closed-ended' refers to an investment fund whose units are not redeemable. The term 'mutual fund', as defined in securities legislation,[3] is not relevant for tax purposes. Rather, the status of a fund as a 'mutual fund trust' or 'mutual fund corporation', as defined by the Act, is the key factor in determining its eligibility for the preferential tax treatment afforded under the Act.[4]

A mutual fund can be established as a trust or a corporation.[5] For the past half century, trusts have been the vehicle of choice by most promoters in Canada, primarily because:

- trusts are very flexible in terms of their structure, administration and operation;
- trusts are not subject to business corporation legislation or comparable legislation; and
- trusts provide a near perfect flow-through for tax purposes.

More recently, corporations have become a popular mutual fund vehicle, largely because of a tax-deferral advantage that can be achieved by investors if multiple funds (ie, separate asset pools) are created as classes of a single corporation. Mutual fund corporations are subject to the same securities regulatory regime as trusts, though they are also subject to business corporation legislation. There are several similarities between the taxation of mutual fund trusts and mutual fund corporations, but there are also some significant differences.

Often, the negative tax impact arising from the choice of legal vehicle can be minimized through structuring and investment mandate. Structuring considerations are not the focus of this chapter.

1. Status of a mutual fund for tax purposes

(a) Status of a trust fund for tax purposes

(i) General

A mutual fund established as a trust should have been structured to qualify as a 'unit trust' so that it will be able to qualify as a 'mutual fund trust', and will not be subject to the 21-year deemed disposition rule.[6]

A trust that qualifies at the relevant time or times as a 'mutual fund trust' under the Act is entitled to preferential tax treatment in a number of ways. For example, the units of a mutual fund trust are qualified investments for a registered retirement savings plan (RRSP), registered retirement income fund (RRIF), deferred profit savings plan (DPSP), registered education savings plan (RESP), registered disability savings plan (RDSP) and tax-free savings account (TFSA). A mutual fund trust (other than a money market fund) is eligible to elect a 15 December taxation year-end. A mutual fund trust may elect, under subsection 39(4), so that its Canadian securities will be treated as capital assets producing capital gains and losses, even if the fund is a trader or dealer. A mutual fund trust is eligible to claim the capital gains refund. A mutual fund trust is exempt from the application of alternate minimum tax, the mark-to-market and specified debt obligation rules in sections 142.2 to 142.5, Part XII.2 tax and certain other adverse tax rules. Capital gains may be distributed by a mutual fund trust to non-residents without the application of withholding tax, except in limited circumstances. A mutual fund trust may be merged into another trust on a tax-deferred basis.

(ii) Unit trust

The Act contemplates both open-ended and closed-ended unit trusts, in each case whether holding a traditional portfolio of securities or real property. The criteria to qualify as an open-ended unit trust for tax purposes are easier to satisfy for most funds, yet an open-ended trust is taxed in the same manner as a closed-ended trust. For this reason, many funds that are not mutual funds for securities law purposes are structured to qualify as an open-ended 'unit trust' for tax purposes, even though the redemption feature is not intended or expected to be the key liquidity mechanism. A classic example is an exchange-traded fund (ETF), such as Barclays' iShares, where units of the fund are listed on a stock exchange and also may be redeemed.

A trust will qualify as a 'unit trust' for tax purposes if it meets the following criteria:

- it is an *inter vivos* trust;[7]
- the interest of each beneficiary is described by reference to units of the trust;
- it is required to accept at the demand of a unitholder the surrender of fully paid units for a price that is determined and payable in accordance with terms included in the trust agreement; and
- the redeemable units represent at least 95% of the fair market value of all issued units.

Alternatively, a trust will qualify as a 'unit trust' for tax purposes if it meets the following criteria:

- it is an *inter vivos* trust;
- the interest of each beneficiary is described by reference to units of the trust;
- the trust is resident in Canada throughout its taxation year;
- throughout the portion or portions of the taxation year (the 'relevant periods') that it did not qualify as a unit trust under the criteria set out above, the trust's only undertaking was:

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- the investing of the trust's funds in property (other than real property or an immovable or a real right in an immovable), and for this purpose, if the trust holds a limited partnership interest it will not be considered to carry on the business of the partnership;[8]
- the acquiring, holding, maintaining, improving, leasing or managing of any real property or an immovable or a real right in an immovable that is capital property of the trust; or
- any combination of the above;

- throughout the relevant periods at least 80% of its property consisted of any combination of:
  - shares;
  - any property that, under the terms or conditions of which or under an agreement, is convertible into, is exchangeable for or confers a right to acquire, shares;
  - cash;
  - bonds, debentures, mortgages, hypothecary claims, notes and other similar obligations;
  - marketable securities;
  - real property situated in Canada and interests in such real property, or immovables situated in Canada and real rights in such immovables; and
  - rights to and interests in — or, for civil law, rights in or to — any rental or royalty computed by reference to the amount or value of production from a natural accumulation of petroleum or natural gas in Canada, from an oil or gas well in Canada or from a mineral resource in Canada;

- not less than 95% of its income for the current year or each of the relevant periods (in each case, ignoring the deduction permitted for income paid or made payable by the trust and also ignoring deemed gains or losses arising on the expiry of options issued by the trust on its units) was derived from, or from the disposition of, those investments listed immediately above;
- throughout the relevant periods, not more than 10% of the trust's property consisted of bonds, securities or shares in the capital stock of any one corporation or debtor other than the Canadian federal government or a provincial or municipal government in Canada; and
- where the trust would not be a unit trust at the particular time if it did not hold Canadian real property or immovables (or interests therein), the units of the trust are listed at any time in the current year or in the following taxation year on a prescribed stock exchange in Canada.

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(iii) Mutual fund trust
For tax purposes, a 'mutual fund trust' is a 'unit trust' resident in Canada that meets the following criteria:

- its only undertaking is:
  - the investing of the trust's funds in property (other than real property or an immovable or a real right in an immovable), and for this purpose, if the trust holds a limited partnership interest it will not be considered to carry on the business of the partnership;[9]
  - the acquiring, holding, maintaining, improving, leasing or managing of any real property or an immovable or a real right in an immovable that is capital property of the trust; or
  - any combination of the above;

- either:
  - a class of units of the trust are 'qualified for distribution to the public'[10] — which for tax purposes means a class of units lawfully distributed by prospectus, or in some cases by offering memorandum; or
  - where the trust was created after 1999, units have been lawfully distributed by prospectus exemption;[11]

- the trust has 150 (or more) beneficiaries, each of whom holds at least one block of the units that are described above (ie, the class of units were qualified for distribution to the public or otherwise lawfully distributed) having an aggregate fair market value of at least $500.[12] A 'block of units' means 100 units, if the fair market value of one unit of the class is less than $25; 25 units, if the fair market value of one unit of the class is $25 or more, but less than $100; and 10 units, if the fair market value of one unit of the class is $100 or more;[13] and

- either:

  - it can reasonably be considered that the trust (having regard to all the circumstances, including the terms and conditions of the units of the trust) was not established or is maintained primarily (ie, 50%) for the benefit of non-resident persons; or
  - less than 10% of the assets of the trust consist of 'taxable Canadian property', as that term is defined in subsection 248(1) without reference to paragraph (b) [business assets].[14]

(iv) Becoming and ceasing to be a 'mutual fund trust' — the 150 investor threshold
A trust will be a mutual fund trust under the Act at any time it satisfies all of the conditions set out above. For most purposes, it is important that a fund be a 'mutual fund trust' throughout its taxation year. However, it is generally not possible for a mutual fund to have 150 investors throughout its first taxation year, because it is not possible for the fund to have 150 investors from the moment of its inception. Similarly, it is generally not possible for a mutual fund to have 150 investors throughout its final taxation year (which, by quirk of tax law, is considered to continue to the trust's ordinary taxation year-end, even if the trust is terminated mid-year). Accordingly, the Act includes two deeming rules to address the situation.

A) Year of formation: If a trust satisfies all of the conditions to be a mutual fund trust on or before the 90th day after the end of its **first** taxation year,[15] the trust may elect in its first tax return to be a mutual fund trust for tax purposes from the date of its creation until the time of the election.[16] There is no prescribed form for the election. If the trust does not properly file the election, it will be a mutual fund trust only when it meets all of the conditions.

B) Other years: There is a relieving rule that deems a trust to be a mutual fund trust for tax purposes throughout a calendar year where the trust was a mutual fund trust at the beginning of the year, but ceased to be one during the year for any one of the following three reasons:

(a) the trust failed to satisfy the conditions required to be an open-ended unit trust (ie, the requirement that at least 95% of the fair market value of the issued units be redeemable on the demand of the holder);
(b) the trust failed to satisfy the 150 investor threshold (ie, in respect of the class of units that was qualified for distribution to the public or otherwise lawfully distributed); or
(c) the trust ceased to exist.

For the deeming rule to apply, the trust must satisfy all the other conditions necessary to attain mutual fund trust status throughout the portion of the year that it was in existence.[17]

This relieving rule was introduced, at least in part, to correct a technical anomaly that led to unintended tax consequences in the terminal year of a mutual fund trust.[18] However, on a plain reading, the rule applies whether or not a fund ceases to exist. Accordingly, it appears that this deeming rule provides relief to a fund that attained mutual fund trust status, but would otherwise loose its status because the number of investors dipped below the 150-investor threshold at some point (or multiple points) during a calendar year. This is welcome relief.

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