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Investment Funds Welcome Fixes to Trust Loss Restriction Event Rules

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Certain investment funds that are trusts may benefit from new proposed legislation that provides relief from potentially harsh tax consequences that extends the tax loss restriction rules to trusts. Finance's proposals, which were released January 15, 2016, clarify the type of investment fund that may be excluded from the loss restriction events that would otherwise limit a trust's use of certain tax attributes and other related changes. Although affected investment funds may find the proposed amendments offer relief, more clarification on certain proposals would be welcome.

The proposed legislation generally implements recommendations made in a Finance comfort letter released December 2014 and appear intended to ensure that certain investments and redemptions related to these investment funds are not inadvertently caught by these rules. Specifically, the proposed legislation includes amendments to:

- Refine the definition of "investment fund" to which the trust loss restriction rules apply
- Exempt certain investment funds from the trust loss restriction rules where an investor becomes a "majority interest beneficiary"
- Address concerns that a loss restriction event could be triggered without any changes to a trust's beneficiaries by clarifying the meaning of "majority interest beneficiary"
- Extend the filing deadlines for certain payments and filing obligations for trusts subject to a loss restriction event
- Amends the coming-into-force rules to provide more flexibility for electing various coming-into-force dates.

Finance will accept comments on the proposed legislation until February 15, 2015. Please reach out to your KPMG advisor if you would like to discuss any concerns with the proposed amendments.

Background
The 2013 federal budget introduced the trust loss restriction rules. Previously, these rules applied only to corporations when there was an acquisition of control of the corporation. The new rules, which are intended to prevent arm's-length parties from engaging in tax loss trading transactions, are triggered by a "loss restriction event". Generally, a "loss restriction event" will occur when a person (together with any affiliated persons), or a

group of persons, acquires more than 50% of the fair market value of the income (or capital) interests in a trust.

Generally, a majority interest beneficiary of a trust is a beneficiary who, together with persons with whom the beneficiary is affiliated, has a beneficial interest in the trust's income or capital with a fair market value (FMV) that exceeds 50% of the FMV of all the beneficial interests in income or capital respectively, in the trust. A majority interest group of beneficiaries of a trust at any time means a group of persons, each of whom is a beneficiary under the trust at that time such that, if one person held the interests as a beneficiary of all of the members of the group, that person would be a majority interest beneficiary of the trust and if any member of the group was not a member, this test would not be met (see *TaxNewsFlash-Canada* 2014-12, "Investment Funds May Be Caught By Trust Loss Restriction Rules").

Tax consequences to a trust resulting from a loss restriction event may include a deemed tax year-end, realization of accrued losses on capital property, and limitations on the use of certain unused losses and carry back of certain net capital losses and property losses.

In response to industry concerns about added investor costs that would arise from these rules, the government enacted relieving legislation in December 2014 to:

- Ensure that certain acquisition of equity in certain types of commercial investment funds will not be treated as a loss restriction event, provided the acquisition is not part of a series of transactions or events under which the trust becomes a "portfolio investment fund" or ceases to qualify as an investment fund
- Extend the deadline for trusts to file and remit certain returns and payments to 90 days of the trust's ordinary year-end (from within 90 days of a loss restriction event as a result of a deemed year-end)
- Specify that these relieving amendments come into force on March 21, 2013, unless the trust makes an election to apply the relevant provisions from January 1, 2014.

In response to further industry concerns, Finance provided a comfort letter dated December 23, 2014 intended to ensure that certain investments and redemptions related to certain commercial investment funds are not inadvertently caught by these rules. The letter recommending further amendments to the trust loss restriction rules to mitigate certain unintended consequences (see *Canadian Tax Adviser*, "Extra Strength Relief for Trust Loss Restriction Event", dated January 13, 2015).

Relief for the trust loss restriction rules

Finance has clarified the types of investment funds to which the rules apply by replacing the current definition of "investment fund" with a new definition that requires investment funds to satisfy new requirements.

First, to meet the proposed definition of "investment fund", the trust must have an outstanding class of units that are qualified for distribution, or lawfully distributed, to the public (as described in the Income Tax Regulations) since March 21, 2013 or after that time if the trust was created subsequently.

Second, the trust must be a non-discretionary unitized trust and satisfy all of the following conditions since March 21, 2013 or after that time if the trust was created subsequently. The trust must:

- Derive, in any combination of the following, all or substantially all of its value, directly or indirectly, from any one or combination of cash, cash equivalents (including bank and credit union deposits), commodities and a diversified portfolio of securities
- Limit its undertaking to investing
- Be resident in Canada
- Limit its undertaking to investing of its funds in property
- Not legally control, alone or as part of a group, a corporation
- Not hold property or an interest in property that is used in carrying on of a business or that is real property, is immovable property or is resource property
- There are no beneficiaries which derive income or capital from the trust other than from fixed interest
- Not hold more than 20% of any class of securities (not including liabilities) of an issuer (other than an investment fund) unless:
  - The total fair market value of the trust's property that is equity (not including liabilities) of the issuer does not exceed 10% of the issuer's equity value, and
  - The total fair market value of the trust's property that are liabilities of the issuer does not 10% of the total fair market value of all of the issuer's liabilities.

KPMG observations

Although the proposed legislation retains the existing securities concentration exemption for fund-on-fund investment, it appears to only apply where an underlying fund held by a trust meets the definition of an "investment fund". It appears that there is no relief for an underlying non-resident fund (e.g., U.S. ETFs, UCITS funds) held by the Canadian trust since the fund, which may be regulated, is not resident in Canada or, in many cases, is not regarded as a trust under Canadian legal entity characterization rules. Additionally, if the underlying fund is not an investment fund, then the top fund may not be able to satisfy the requirements under the proposed definition, depending on the amount of their overall investment in the non-resident investment fund..

The proposed definition permits an investment fund to hold one or a combination of investment instruments, including money and or deposits within the meaning assigned by the Canada Deposit Insurance Corporations Act (CDIC) or with a bank branch in Canada or a credit union. It is unclear whether the new definition was intended to restrict certain types of deposit accounts held by the investment fund to only federal and provincial institutes (as defined by the CDIC) as there are a number of instances where investment

funds have deposits held in financial institutions which are not federal or provincial members under the CDIC.

Under the proposed definition, a trust cannot hold an interest in (or a right to) real, immovable or resource property. Investment funds would need to determine whether certain fixed or equity instruments, including investments in non-resident partnerships, would provide for an interest and or a right in real, immovable or resource property. This is because, under the laws of some foreign jurisdictions, an investor may have an undivided interest or right to the property of the investee where the instrument does not provide for such an interest.

The proposed legislation amends the definition of the balance due date when a loss restriction event has occurred. Depending on the taxation year-end of the investment fund trust and when the loss restriction event occurs, this can appear to give rise to an inconsistency between the election available to be a mutual fund trust and the election to have a taxation year-end ending on December 15.

Events not giving rise to the loss restriction event rules

Generally, an investor may become a majority interest beneficiary of a trust by acquiring units in that trust. Alternatively, an investor may become a majority interest beneficiary because another investor has redeemed units in that trust.

Previously, Finance's legislation released in December 2014 provided limited relief so that a person or group of persons were deemed not to have become a majority interest beneficiary through the acquisition of equity of a particular trust. Finance has now proposed an amendment to address a concern about circumstances in which an investor becomes a majority interest beneficiary as a result of another investor's redemption of equity in the trust.

Under this new provision, a disposition of equity in an investment fund (as well as an acquisition) is not considered a loss restriction event if certain conditions are met. This measure is subject to an anti-avoidance rule that requires that the acquisition or disposition cannot be part of a series of transactions or events under which the trust ceases to qualify as an investment fund.

Loss restriction events without changes in a trust's beneficiaries

Finance has proposed amendments to the definition of "majority interest beneficiary" so that a majority interest beneficiary of a trust at any time means a person that is at that time both a beneficiary under the trust and a majority interest beneficiary of the trust.

Application rules

The proposed amendments addressing the definition of "investment fund", loss restriction events on redemption, and loss restriction events without changes in a trust's beneficiaries, are deemed to have come into force on March 21, 2013. However, a trust may elect in writing

to have the proposed rule on loss restriction events on redemption apply as of the first day of the trust's 2014 or 2015 taxation year. The trust must file the written election on or before the trust's filing due date for its last 2014 taxation year.

A proposed anti-avoidance provision generally applies to the legal control and percentage of securities ownership requirements.

Filing due dates

Generally, the proposed amendments extend the time which trusts have to must remit income taxes and file any returns for a pre-loss restriction event year (a pre-LRE year) under changes to the definition of "balance-due day".

For a pre-loss restriction event year, the trust's filing date (as well as for its T3 information slips for that year) is its balance-due day of its ordinary taxation year (i.e., 90 days after what would have been the trust's taxation year-end if the deemed shortened year did not apply),

Where the trust's following taxation year ends in the same calendar year as the pre-LRE year, the trust's balance-due day is its balance-due day for that immediately following taxation year (e.g., where a trust's following taxation year ends on December 31 of the calendar year in which the pre-LRE year ends, its balance-due day for the pre-LRE year is 90 days after that following taxation year).

Different rules apply for a trust that is subject to a loss restriction event immediately after the end of the taxation year and the trust's following taxation year does not end in the calendar year in which the taxation year ends.

The amendments also extend deadlines for other requirements, such as NR4 returns, T3 Schedule 10 returns, T3RI returns and elections for a trust to be treated as a mutual fund from the beginning of its first taxation year. The proposals also extend deadlines relevant to the election of mutual fund status and computing interest on a mutual fund trust's capital gains refund for a pre-LRE year.

Tax year-end amendments

Under the amendments, where a mutual fund trust ceases to be resident in Canada or where that trust is subject to a loss restriction event, then that trust is exempt from the rule that provides for an election for a mutual fund trust's taxation year-ends to be December 15.

Finance has proposed an amendment so that a trust cannot elect to extend a preceding taxation year. Currently, a taxpayer subject to a loss restriction event within seven days of the end of the taxpayer's preceding taxation year can generally elect to extend the preceding taxation year to include those additional days.

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We can help

KPMG is committed to the wealth and asset management industry, to which the tax loss restriction rules are expected to have a significant impact. Your KPMG adviser can help you assess the potential impact of the rules and outline all the necessary steps you should take.

For details, please contact your KPMG adviser or one of the following:

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