KPMG

TaxNewsFlash Canada

Financial Services Industry — Prepare for 2016 Budget Measures

March 24, 2016
No. 2016-13

The financial services industry may want to start preparing for the effect of certain tax changes proposed in the 2016 federal budget. Specifically, the budget proposes corporate and indirect tax measures for:

- Mutual fund corporation ("switch funds") share exchanges
- Sale of linked notes
- Derivatives — Lower of cost or market
- The closely related test for GST/HST elections
- GST/HST on cross-border reinsurance with affiliates
- GST/HST *de minimis* financial institution— Interest from GICs or deposits
- Zero-rated call centre services to non-residents.

The budget introduces a "bail-in" regime to protect taxpayers in the event of a large bank failure. This would allow authorities to convert eligible long-term debt of a failing bank into common shares to recapitalize the bank and allow it to remain in operation. Finance has indicated that legislation implementing this measure will follow, and that stakeholders will have an opportunity to provide comments.

The budget also commits $4.2 million over five years for Finance to review banking and insurance legislation and extends the current statutory sunset date to March 29, 2019.

Finance also stated that it will provide technical amendments to ensure the integrity of the tax system.

Background

Finance Minister Bill Morneau delivered the government's 2016 federal budget on March 22, 2106. For full details of the budget, see *TaxNewsFlash-Canada* 2016-12, "2016 Federal Budget Highlights".

Mutual fund corporation ("switch funds") share exchanges

Mutual fund and investment corporations organized as multiclass investment funds for regulatory purposes ("switch funds") currently allow investors to exchange a class of shares for other investment fund classes within the same corporate entity without triggering a disposition for income tax purposes. The budget proposes to treat these exchanges of shares as a taxable disposition at fair market value.

The proposed measure will not apply to exchanges where the class series exchanged differ only in respect of management fees or expenses to be borne by investors.

Detailed legislation regarding these proposed measures has yet to be released. This measure will apply to exchanges between share classes that occur after September 2016.

KPMG observations

Although Finance has not yet provided detailed legislation, there are a number of operational and regulatory consequences to the investment fund industry in addition to costs and potential double taxation implications which can arise for investors.

Sale of linked notes

Currently, a taxpayer can potentially apply capital gains treatment to gains from the disposition of a linked note sold on a secondary market. A linked note that was held to maturity would generally be taxed on account of income.

The budget proposes amendments 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. In particular, a deeming rule will apply in certain cases, to 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. The budget also provides an exception where a portion of the return on a linked note is based on a fixed rate of interest. In this 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.

KPMG observations

This measure is expected to reduce trading activities of linked notes on the secondary market. Currently, issuers of linked notes often establish a secondary market where investors can sell their linked notes before maturity to an affiliate of the issuer.

Foreign currency fluctuations will be ignored for the purposes of calculating the gain that is deemed to be interest. The character of the foreign currency gain will therefore be established using general principles applicable to the taxation of foreign exchange gains and losses and, depending on the taxpayer's particular facts and circumstances, the foreign currency gain or loss may be treated on capital account.

Where a portion of the return on a linked note is based on a fixed rate of interest, any portion of the gain that is reasonably attributable to market interest rate fluctuations will be excluded from the deeming rule. This means that taxpayers may be able to recognize the gain or loss attributable to interest rate movements on capital account depending upon their specific facts and circumstances.

Derivatives — Lower of cost or market

Generally, inventory can be measured at the lower of cost or market value for tax purposes. To the extent that the fair value is less than cost, the difference is deductible in computing taxable income. However, no amount is added to income if the fair value exceeds cost except where a disposition has occurred, unless such property is subject to the mark-to-market (MTM) rules that apply to financial institutions.

The budget proposes to exclude derivatives from the application of the inventory valuation rules and more generally preclude derivatives from the application of the lower of cost or market method for the computation of taxable income.

This measure will apply to derivatives entered into on or after March 22, 2016.

KPMG observations

This measure seems to address recent jurisprudence that found that certain derivatives held on income account would generally be considered inventory of the taxpayer and would therefore qualify for the lower of cost and market methodology under the tax rules.

These changes should not affect MTM property held by financial institutions. Investment funds that previously applied the accrual method for the tax treatment of certain derivative instruments should revisit their position in order to ensure compliance with the recent proposals. Investment funds (except funds which are otherwise deemed financial institutions) that have recognized gains or losses using the realization of income principles for derivatives (i.e., recognizing gains or losses on disposal) should be unaffected by the budget proposals. However, funds should review such contracts to ensure the appropriate tax treatment is being applied.

The closely related test for GST/HST elections

The budget proposes a new condition under the closely related test. This change will affect corporations with section 150 elections in place where there may be different voting rights for different categories of shares and a new measure in cases where another person (other than the owner of the share) may control the voting rights attached to shares.

This budget measure proposes an additional test for the closely related group election where the other corporation must hold "qualifying voting control". To meet this new test, the other corporation must generally own shares of the corporation to which are attached at least 90% of shareholder votes that may be cast in respect of each corporate matter (some exclusions apply).

The budget also proposes that, in some cases, a person will be deemed not to own a share where another person has a right under a contract, in equity or otherwise to control the voting rights attached to the share. Based on the new test and/or the new deeming provision, some entities will no longer be members of a closely related group.

For new section 150 elections, the new measure will apply to elections filed after March 22, 2016 and that are to be effective after that day. For previously filed elections, the new measure will generally apply the day that is one year after March 22, 2016 with some exceptions.

KPMG observations

As a result of this measure, corporations with section 150 elections should:

- Review previously filed closely related group elections to determine if all corporations meet the new "qualifying voting control" test
- Determine if the new deeming provision will apply and disqualify members from a previously filed election
- Determine the effect of an entity being required to charge GST/HST on certain supplies and how to mitigate the additional unrecoverable tax
- Determine the effect of no longer being a listed financial institution (e.g., review rules related to annual information returns, allocation between exempt and taxable activities, self-assessment requirements, change of use rules).

GST/HST on cross-border reinsurance with affiliates

The budget introduces legislation to give effect to two Finance letters to the insurance industry on cross-border reinsurance with non-arm's length reinsurance. The letters are dated October 21, 2014 and February 26, 2015.

Specifically, the budget proposes to clarify that two specific components of imported reinsurance services, ceding commissions and the margin for risk transfer, do not form part of the tax base that is subject to the self-assessment provisions contained in the GST/HST imported supply rules for financial institutions and to set out specific conditions under which the special rules for financial institutions do not impose GST/HST on reinsurance premiums charged by a reinsurer to a primary insurer.

KPMG observations

The proposed amendments appear to confirm Parliament's intention not to tax the portion of the profit margin on reinsurance arrangements that relate to risk and the portion of premiums returned to the ceding insurer as a ceding commission.

However, some reinsurance arrangements do not appear to fit readily within the proposed new definitions of "ceding commissions" and "returned commissions". For example, amounts described as ceding commissions in some life reinsurance arrangement often designate a prepayment of future profits on (past) ceded claims. Such arrangements may not fall within the proposed definition of "ceding commission", which is based on "expenses incurred exclusively in Canada [by the ceding insurer] to issue and administer the particular insurance policies."

Moreover, while the new definition of "margin for risk transfer" clarifies that reinsurance profits may not be subject to self-assessment, it creates additional uncertainty on the application of "loading" to other financial services.

As announced in the Finance letters, the proposed amendments also introduce a new "permitted deduction" from self-assessment for affiliate reinsurance arrangements that meet certain criteria (e.g., compliance with regulatory requirement and transfer pricing rules). However, it is not presently clear how these criteria will be applied in practice.

In addition, some elements of the Finance letters are missing from the new proposals. The proposed amendments only refer to "[service] agreements in writing", whereas the Finance letters contemplated "documented head office allocation charges." The CRA will have to clarify how it will administer the new proposed amendment where the taxable administrative services are received from a foreign branch of the ceding insurer rather than from a separate legal entity, or when there are cost recharges but no actual written agreement in place governing taxable administrative services.

The coming into force provisions of the proposed amendments address the CRA's ability to issue rebates. The CRA states, in Notice 287, that it "[could not] pay any rebate claims in respect of these matters based on the current legislation." However, such rebate claims will be subject to a one-year limitation period from the date the amendments receive Royal Assent. It is currently unclear whether the CRA will issue rebates before these changes receive Royal Assent.

GST/HST *de minimis* financial institution rules — Interest from GICs or deposits

Based on the CRA's interpretation, interest from GICs and deposits are considered interest from the lending of money and therefore can cause an entity making these types of deposits to be considered a *de minimis* financial institution under the GST/HST rules.

The determination of an entity's status under the *de minimis* financial institution rules is based on whether the entity has more than $1 million interest income or separate fee charge from financial services in the preceding taxation year.

The budget proposes to exclude interest for demand deposits, term deposits and guaranteed investment certificates (GICs) with an original due date to maturity not exceeding 364 days. The

measures also provide rules for determining the 364 days limit where there is a right to withdraw, reinvest or extend the term of the deposit.

In general, under the coming into force provision, the new exclusion will generally apply to taxation years of an entity that begins on or after March 22, 2016. For 2017, some entities will no longer be financial institutions and will need to consider the potential benefits or drawbacks of a change in this status.

However, for purposes of determining if the entity is required to file the GST/HST Annual Information Return (AIR), the new measure applies to the fiscal year that begins before March 22, 2016 and ends on or after March 22, 2016.

Zero-rated call centre services to non-residents

The budget proposes a new zero-rating provision for exported call centre services that may affect financial institutions. To qualify, among other conditions:

- The supply must be made to a non-resident person who is not registered for GST purposes and is not the consumer of the services, and
- It must be reasonable to expect that the technical or customer support is to be rendered primarily to individuals who are outside Canada.

The new provision excludes a supply of an advisory, consulting or professional service and a supply of acting as an agent of the non-resident person or arranging for or soliciting orders of supplies.

This measure applies to any supply made after March 22, 2016 or to any supply made on or before if the supplier did not charge, collect or remit tax related to the supply.

Other tax measures affecting financial institutions

Eligible capital property — Income change in status

For income tax purposes, eligible capital property (e.g., goodwill) will become capital property on January 1, 2017 in the new Class 14.1 of Schedule II to the Income Tax Regulations. Due to this change, the definition of “capital property” will be amended for *Excise Tax Act* purposes to exclude property described in Class 14.1 of Schedule II to the Income Tax Regulations. As such, items that are eligible capital property will still not be subject to the capital property rules for input tax credits, sales of property and change of use rules.

Outstanding tax measures

The 2016 federal budget confirms the government’s intention to proceed with the following tax and related measures that were announced in the current session of Parliament but have not yet been legislated:

- The common reporting standard established by the Organisation for Economic Co-operation and Development for the automatic exchange of financial account information between tax authorities

The 2016 federal budget also confirms the government's intention to proceed with tax and related measures, as modified, to take into account consultations and deliberations since their announcement or release, relating to:

- "Synthetic equity arrangements" under the dividend rental arrangement rules
- The conversion of capital gains into tax-deductible inter-corporate dividends (section 55)
- The offshore reinsurance of Canadian risks
- An exception to the withholding tax requirements for payments by qualifying non-resident employers to qualifying non-resident employees
- The sharing of taxpayer information with the Office of the Chief Actuary
- The GST/HST joint venture election.

We can help

Your KPMG adviser can help you assess the effect of the tax changes in this year's federal budget on financial institutions. We can also keep you abreast of the progress of these proposals as they make their way into law.

---

kpmg.ca