2016 Canadian Federal Budget: Financial Products Update

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Agenda

- March 22, 2016 Canadian Federal Budget
  - Secondary Market Sales of Linked Notes
  - Taxation of Switches in Mutual Fund Switch Corps
  - Extension of the Back-to-Back Rules
  - Valuation of Derivatives for Tax Purposes
Background to Budget Proposal Concerning Secondary Market Sales of Linked Notes

- Most linked notes are considered to be covered by Reg. 7000(1)(d) and subject to the deemed interest accrual rules
- The CRA's long-standing administrative position has been that there is no requirement to accrue an amount on account of interest until amount payable on note is calculable
- The CRA has been reviewing this position for many years

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- Any amount received at maturity that is greater than the principal amount would generally give rise to a full income inclusion, while a note sold prior to maturity would generally give rise to a capital gain
- Any amount received at maturity that is less than the principal amount would generally give rise to a capital loss
Budget Proposal Regarding Secondary Market Sales of Linked Notes

- The Budget proposes to override capital gains treatment for secondary market sales of such structured notes.
- Applicable to Reg. 7000(1)(d) prescribed debt obligations (most linked notes).
- Applicable for dispositions on or after October 1, 2016.

Budget Proposal Regarding Secondary Market Sales of Linked Notes (Cont’d)

- The amount deemed to be interest would generally be the difference between the sale price and the principal amount of the note.
- Foreign currency fluctuations will be ignored for purposes of this calculation.
- Also an exception for any portion of the excess that is reasonably attributable to any increase in the value of fixed rate interest payments.
- Application to deemed dispositions?
Budget Proposal Regarding Secondary Market Sales of Linked Notes (Cont’d)

- Proposal does not affect the accrual of interest on Reg. 7000(1)(d) prescribed debt obligations before sale
- Not clear whether the CRA’s review of its administrative position is ongoing

Background to Budget Proposal Regarding Mutual Fund Switch Corps

- A “switch corp” is a single mutual fund corporation that has a number of classes of shares, each of which is a separate mutual fund under securities law
- Currently, a “switch” from one class to another is deemed not to be a disposition pursuant to section 51
- This allows investors to change funds without incurring tax
Budget Proposal Regarding Mutual Fund Switch Corps

- Budget proposes that switches between classes will now be a taxable event
- Narrow exception is provided for conversions where the shares received on a share conversion differ only in respect of management fees or expenses to be borne by investors
- Applicable for “switches” on or after October 1, 2016

Budget Proposal Regarding Mutual Fund Switch Corps (Cont’d)

- Currently, no tax-efficient way to facilitate a conversion of a class of shares of a switch fund to a separate mutual fund trust
- Effect on capital gains redemption calculation?
Budget Proposal Regarding Back-to-Back Rules: Background

- The “back-to-back” (BTB) loan rules were first proposed in 2014 federal budget
- Anti-avoidance rules designed to prevent taxpayers from circumventing Canada's withholding tax and thin capitalization rules by structuring lending transactions through intermediaries
Budget Proposal Regarding Back-to-Back Rules

Budget Proposal:

- The Budget proposes extending the ambit of the existing back-to-back loan rules relating to withholding tax in a number of ways:
  - BTB rules will apply to rents and royalties
  - Character substitution rules to be introduced
  - “Clarification” of the application of the BTB rules in arrangements involving multiple intermediaries
  - BTB rules will also apply in an upstream context

Budget Proposal Regarding Back-to-Back Rules: Extension to Rents, Royalties and Similar Payments

- Aimed at treaty shopping where rents, royalties or similar payments are paid to an intermediary in a favourable jurisdiction
- Rule will generally apply where:
  - Payment made by a Canadian resident to an intermediary in a treaty jurisdiction (“Canadian leg”)
  - Intermediary has an obligation to pay an amount to a non-resident (“Intermediary leg”)
  - Either of the following conditions is met:
    - Amount paid under the Intermediary leg is established by reference to the amount paid under the Canadian leg or the FMV of, revenue from or profits from the Canadian leg; or
    - It is reasonable to conclude that the Canadian leg was entered into because the Intermediary leg was entered into
Budget Proposal Regarding Back-to-Back Rules: Extension to Rents, Royalties and Similar Payments (Cont’d)

- BTB rule would apply where withholding tax on payments under Canadian leg is lower than had payments been made to Intermediary leg recipient
- Where rules apply, payor under the Canadian leg is deemed to have made payment directly to the recipient under the Intermediary leg for withholding tax purposes
- Implications for arm’s length royalty payments?
- Applies to payments made after 2016
Budget Proposal Regarding Back-to-Back Rules:
Character Substitution Rules

- Extension of BTB rules to circumstances where arrangements under the intermediary leg are not in the same form as the Canadian leg but are economically similar to the intermediary leg.
- Includes situations where the Intermediary leg payment is a dividend.
- Character substitution rule will apply only where a sufficient connection is established between the Canadian leg and the Intermediary leg.

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- Where the character substitution rule applies, the Canadian resident payor will be deemed, for withholding tax purposes, to have made a payment of the same character as made under the Canadian leg directly to the non-resident recipient under the Intermediary leg.
- Not limited to transactions among an affiliated group.
- Applies to payments made after 2016.
Budget Proposal Regarding Back-to-Back Rules: Multiple Intermediaries

- The Budget indicates that there will be a “clarification” of the application of the BTB rules to arrangements involving multiple intermediaries.
- In the context of withholding tax, the objective is to have withholding tax apply as if payments made through a chain had been made directly to the “ultimate recipient.”
- In order for these new rules to apply, a “sufficient connection” test will be introduced.
- Applies to payments made after 2016.

Budget Proposal Regarding Back-to-Back Rules: Shareholder Loans

- Where a non-resident shareholder of a Canadian corporation becomes indebted to such corporation, the amount of the indebtedness is deemed to be a dividend subject to withholding tax.
- Subject to certain exceptions, including repayment before end of next taxation year.
Budget Proposal Regarding Back-to-Back Rules: Shareholder Loans

Direct loan:
- Subject to deemed dividend treatment if not repaid by the end of the year following the year of advance

Indirect loan:
- Can be left outstanding long-term without being treated as a constructive distribution

New BTB rules will apply in the following circumstances:
- a shareholder of a Canadian corporation owes an amount to an intermediary that is not connected with the shareholder; and
- the intermediary either
  - owes an amount to the Canadian corporation and, generally, that receivable supports the debt owing to the intermediary, or
  - the intermediary has a “specified right” granted by the Canadian corporation

Where this BTB rule applies, the shareholder will be deemed to owe an amount directly to the Canadian corporation

Applies as of March 22, 2016
Background to Valuation of Derivatives Budget Proposal: *Kruger Inc. v. R.*

**Facts:**
- Kruger was a private corporation that was heavily exposed to currency fluctuations.
- Kruger was engaged in derivatives trading for speculative profit.
- Kruger deducted unrealized losses on such options in computing its income under section 9.
- Minister reassessed on the basis that losses could not be claimed until realized.

*Kruger Inc. v. R.* (Cont’d)

**Issues:**
- Could the options be reported on a mark-to-market basis for income tax purposes rather than on a realization basis?
- In the alternative, were the options inventory for income tax purposes such that they could be valued at the lower of cost and market in accordance with subsection 10(1)?
**Kruger Inc. v. R.** (Cont’d)

**Decision:**

- Court rejected Kruger’s position that computing profit for purposes of subsection 9(1) could be done on a mark-to-market basis rather than on a realization basis.
- Court accepted that purchased options could be inventory but not written options.

**Budget Proposal Regarding Valuation of Derivatives**

- Budget proposes to override determination in Kruger that purchased derivatives could be subject to “lower of cost and market” inventory valuation rules.
- Budget also proposes that section 9 cannot be used to claim a “lower of cost and market” deduction.
- Proposals would not affect derivatives that are “mark-to-market properties” held by a financial institution.
- Implications for taxpayers that mark-to-market their derivatives under subsection 9(1)?