Policy Forum: Hidden Tax Traps in Section 132.2 Mergers—Trusts, REITs, and Other Businesses

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ABSTRACT

This brief article reviews a number of anomalies in the Income Tax Act (Canada) concerning mergers of mutual fund corporations and mutual fund trusts that could result in tax being exigible as a consequence of such mergers. The authors comment on a recent comfort letter issued by the Department of Finance that addresses these anomalies.

KEYWORDS: TRUSTS ■ EXCHANGES ■ MUTUAL FUNDS ■ REAL ESTATE INVESTMENT TRUSTS ■ REORGANIZATION ■ NONRESIDENTS

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Section 132.2 of the Income Tax Act[1] as it is proposed to be amended by the July 18, 2005 draft legislation[2] permits a target mutual fund corporation or a mutual fund trust ("the transferor") to be taken over and merged with another mutual fund trust ("the transferee") supposedly on a rollover basis. However, under the current wording of section 132.2 as well as the proposed amendments, it appears that tax may very well be triggered in carrying out what is otherwise thought to be a tax-free rollover

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1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

2 Canada, Department of Finance, *Legislative Proposals Relating to Income Tax* (Ottawa: Department of Finance, July 2005). Unless otherwise stated, references in this article to the provisions of section 132.2 are to the proposed legislation, not the existing provisions.

transaction. A close analysis of the relevant proposed legislation reveals several unintended potential tax traps. However, according to a "comfort letter" issued by the Department of Finance in February 2006, the department intends to recommend specific amendments that should resolve most of these problems.[3] The hidden traps and the remedies proposed by the department are discussed below.

BACKGROUND

Section 132.2 permits a tax-deferred "merger," known as a "qualifying exchange," of the transferor with the transferee. A merger will be a qualifying exchange provided that

- all or substantially all of the properties of the transferor are transferred to the transferee in exchange for units of the transferee (and possibly the assumption of liabilities);
- contemporaneously, the transferor distributes those units to its shareholders or unitholders, as the case may be, solely in exchange for their shares or units of the transferor; and
- the transferor and the transferee file a prescribed form with the minister electing that the exchange be treated as a qualifying exchange.

Where a qualifying exchange occurs between the transferor and the transferee, generally, the properties of the transferor are transferred to the transferee on a tax-deferred basis and the units of the transferee received by the transferor from the transferee as consideration for its properties are distributed by the transferor to its shareholders or unitholders, as the case may be, for its own shares or units, also on a tax-deferred basis. However, as stated above, a qualifying exchange can result in tax as a consequence of certain technical anomalies.

TIMING

There is a material inconsistency in the definition of "qualifying exchange" in subsection 132.2(1) and the preamble of paragraph 132.2(3)(g) in respect of the time period within which shareholders or unitholders of the transferor must dispose of their shares or units to the transferor in exchange for units of the transferee.

Paragraph (a) of the definition of "qualifying exchange" requires that all or substantially all of the shares or units of the transferor be disposed of to the transferor *within 60 days after the "transfer time"* (defined in the preamble of the definition to be the time when all or substantially all of the property of the transferor is transferred to the transferee).

The preamble of paragraph 132.2(3)(g) provides that the disposition of the shares or units to the transferor in exchange for units of the transferee will occur on

3 See the Department of Finance comfort letter of February 14, 2006, available online in various commercial databases.

a tax-deferred basis only if the exchange takes place *within 60 days after the day that includes the transfer time*. Thus, to engage subparagraph 132.2(3)(g)(i) and provide a rollover to the holders of units or shares of the transferor, the earliest that the exchange can occur is the day that follows the day that includes the transfer time.[4] On the other hand, the transfer of assets by the transferor to the transferee may occur on a rollover basis once the requirements for a qualifying exchange have been met, and this contemplates that such exchange can occur on the same day that includes the transfer time. Moreover, if the exchange of shares or units of the transferor for units of the transferee occurred on the 60th day following the day on which the transfer time occurred, as is contemplated in the preamble to paragraph 132.2(3)(g), the exchange would not be a qualifying exchange because paragraph (a) of the definition requires that the exchange of shares or units occur within 60 days following the transfer time, not 61 days.

This inconsistency does not arise under the current versions of the relevant provisions; the definition of "qualifying exchange" in subsection 132.2(2) and the preamble of paragraph 132.2(1)(j) both refer to the same time period—namely, within 60 days after the transfer time.

As a commercial matter, in the context of a qualifying exchange, the transfer of the properties from the transferor to the transferee and the disposition of shares or units of the transferor to the transferee in exchange for units of the transferee will usually occur on the same day rather than on separate days.

Clearly, in light of the above observations, the commencement of the 60-day time period referred to in paragraph (a) of the definition of qualifying exchange and the commencement of that period for the purposes of subparagraph 132.2(3)(g)(i) should be the same. Since this is not the case as the amendments are now worded, if the exchange of shares or units of the transferor for units of the transferee occurs on the day when all or substantially all of the assets of the transferor are transferred to the transferee (as is generally the case), the exchange will result in a taxable disposition.

This technical problem is addressed in the Department of Finance comfort letter referred to above. The department states that it will recommend to the minister of finance that the Act be amended to clarify that all references to a 60-day period in section 132.2 refer to the same period of time and that the period is to commence on the day that includes the transfer time. More specifically, the references to "the day that includes" in paragraphs 132.2(3)(f) and (g) will be deleted. These changes are to be applicable to qualifying exchanges occurring after 1998.

4 Note that section 27(5) of the Interpretation Act, RSC 1985, c. I-21, as amended, provides that where anything is to be done within a time "after . . . a specified day," the time period "does not include that day."

TAXABLE CANADIAN PROPERTY, EXCLUDED PROPERTY, AND PART XIII.2

Taxable Canadian Property and Excluded Property

Where a transferor acquires its own shares or units from a non-resident holder in the course of a qualifying exchange, and those shares or units are taxable Canadian property that is not excluded property, there is a concern that the transferor may be required, pursuant to subsection 116(5), to withhold tax in respect of the distribution of units of the transferee to the non-resident. Moreover, if such shares or units are taxable Canadian property, the non-resident holder is required to report the disposition to the Canada Revenue Agency (CRA), whether or not the non-resident has realized a taxable capital gain as a consequence of the disposition.[5] The text, context, and purpose of a qualifying exchange, including, in particular, subparagraph 132.2(3)(g)(i) clearly indicate that from the perspective of the holder of shares or units of the transferor (including a holder who is a non-resident), the exchange of those shares or units for units of the transferee in a qualifying exchange is intended to occur on a tax-deferred basis. However, it appears that the shares or units of the transferor may constitute taxable Canadian property at the time of the exchange if paragraph 132.2(3)(n) deems the transferor not to be a mutual fund corporation or a mutual fund trust, as the case may be, at the time that the transferor is considered to have exchanged units of the transferee for its own shares or units in a qualifying exchange.[6]

For example, where the transferor is a publicly traded mutual fund trust and the time of the exchange of units in the transferor for units of the transferee is immediately after the acquisition time, the unitholder will be regarded as disposing of units of a trust that is deemed at that time not to be a "mutual fund trust"; consequently, a non-resident unitholder will be disposing of taxable Canadian property. As a result, unless the non-resident unitholder has obtained a clearance certificate on a timely basis from the CRA in respect of the disposition of the units to the transferor, the transferor will be required, pursuant to subsection 116(5), to withhold tax in respect of the distribution of units of the transferee to the non-resident. In these circumstances, the transferor may be required to sell a certain number of the units of the transferee that it would otherwise have distributed to the non-resident unitholder in order to fund the payment of the tax on the non-resident's behalf. In addition, the non-resident unitholder will be required to file a tax return with the CRA reporting the disposition of units of the transferee that were sold on the non-resident's behalf by the transferor; pay the tax on the taxable capital gains, if any, arising on the disposition; and claim a refund of tax, if any, owing to the non-resident.[7] These tax

5 Subsection 116(3).

6 If the transferor is a mutual fund corporation whose shares are listed on a prescribed stock exchange, those shares will generally not be taxable Canadian property and in any event will be excluded property and therefore exempt, in either case, from subsection 116(5).

7 Clause 150(1)(a)(i)(D) and subparagraph 150(1.1)(b)(iii).

consequences contradict the rollover nature of a qualifying exchange implied by paragraph 132.2(3)(g) and present a significant impediment to effecting a qualifying exchange where the transferor is a publicly traded mutual fund trust with non-resident unitholders.

More particularly, paragraph 132.2(3)(n) deems the transferor not to be a mutual fund corporation or a mutual fund trust, as the case may be, for its taxation years beginning after the transfer time. Pursuant to paragraph 132.2(3)(b), the first taxation year of the transferor after the transfer time begins immediately after the "acquisition time" as defined in paragraph 132.2(2)(c).[8] The actual exchange of units of the transferee by the transferor for its own shares or units clearly occurs after the transfer time (as defined in the definition of qualifying exchange);[9] and because (pursuant to paragraph (a) of the definition of qualifying exchange) the exchange may occur at any time within the 60-day period following the transfer time, it may also occur after the acquisition time, and therefore after the transferor has been deemed by paragraph 132.2(3)(n) not to be a mutual fund corporation or a mutual fund trust. If such exchange occurs before the acquisition time, the transferor will be a mutual fund corporation or mutual fund trust at the time of the exchange of units of the transferee for shares or units of the transferor, and generally, the shares or units of the transferor will not be taxable Canadian property at that time. In these circumstances, subsections 116(2), (3), (4), and (5) will have no application.

However, if the exchange occurs after the acquisition time, the transferor will be deemed not to be a mutual fund corporation or a mutual fund trust at that time. In these circumstances,

- where the transferor is a mutual fund trust, as stated above, its units will be taxable Canadian property and the transferor will potentially be subject to subsection 116(5)[10] in respect of any of its units it acquires from a non-resident in exchange for units of the transferee;
- where the transferor is a mutual fund corporation whose shares are not listed on a prescribed stock exchange, the transferor will also be potentially subject to subsection 116(5) in respect of any of its shares it acquires from a non-resident in exchange for units of the transferee; and
- where the transferor is a mutual fund corporation whose shares are listed on a prescribed stock exchange, it will not generally be subject to subsection 116(5)

8 Paragraph 132.2(2)(c) provides that "the acquisition time" is the time immediately following "the first intervening time" (paragraph 132.2(2)(b)), which in turn is the time immediately following "the transfer time" (paragraph 132.2(2)(a)).

9 The transferor acquires the units of the transferee that it distributes to the holders of its shares or units on the transfer of its properties to the transferee. Therefore, the distribution of those units can only occur after the transfer that marks the transfer time.

10 It is assumed in this discussion that the non-resident shareholder or unitholder does not obtain a clearance certificate from the CRA in respect of the disposition of the shares or units to the transferor.

> in respect of shares it acquires from a non-resident since its shares generally will not be taxable Canadian property, and even if they are, they will be excluded property.

In addition, where the shares or units are taxable Canadian property, a non-resident holder will be required to file a Canadian income tax return reporting the exchange.

These rules illustrate a further inconsistency where the transferor is a mutual fund corporation whose shares are listed on a prescribed stock exchange. As mentioned above, such shares will be excluded property; moreover, the application of paragraph 132.2(3)(n) to the corporation deeming it not to be a mutual fund corporation will not preclude such characterization. This treatment stands in stark contrast to the treatment of shares of a mutual fund corporation that are not listed on a prescribed stock exchange and to units of a mutual fund trust, since those shares or units will cease to be excluded property upon the application, after the acquisition time, of subsection 132.2(3)(n).

The Department of Finance stated in the comfort letter that it would recommend to the minister of finance that the Act be amended to ensure that an exchange of shares or units by a non-resident in the course of a qualifying exchange will not be subject to section 116, effective for qualifying exchanges that occur after June 1994.

Part XIII.2

An additional issue arising in the context of a qualifying exchange is the application of part XIII.2 to the distribution by the transferor to a non-resident of units of the transferee in the course of a qualifying exchange. Mutual fund corporations and mutual fund trusts whose shares or units are listed on a prescribed stock exchange and whose value is primarily attributable to real property in Canada, Canadian resource properties, or timber resource properties, are subject to a tax of 15 percent of the amount of any distribution made by them to non-resident shareholders or unitholders where such distributions are not otherwise subject to tax under part I or part XIII.

For example, assume that a real estate investment trust (REIT) seeks to merge with another REIT using a qualifying exchange to effect the merger. In the course of the qualifying exchange, the transferor will distribute units of the transferee to non-resident holders of units of the transferor. The transferor will be subject to a tax of 15 percent of the fair market value of the units of the transferee distributed by the transferor if it is a mutual fund trust at the time of such distribution. Again, it is clear from the text, context, and purpose of a qualifying exchange that part XIII.2 tax is not intended to apply to a distribution by a transferor of units of a transferee to the non-resident holders of shares or units of the transferor in the context of a qualifying exchange since that exchange is to be effected on a tax-deferred basis.

However, as mentioned, in the context of a qualifying exchange (as defined in the proposed amendments discussed above), the exchange of shares or units of the transferor for units of the transferee can occur at any time in the 60-day period after the transfer time. Although paragraph 132.2(3)(n) deems a transferor not to be a mutual fund corporation or a mutual fund trust, as the case may be, for its first taxation year that commences immediately after the acquisition time, there is nothing in subsection 132.2(3) that deems the exchange by shareholders or unitholders of the transferor that occurs within the requisite 60-day period to have occurred after the acquisition time. Accordingly, if the distribution of units of the transferee by the transferor occurred after the transfer time, but before the acquisition time when the transferor was a mutual fund corporation or a mutual fund trust, as the case may be, the distribution of the units of the transferee by the transferor to the shareholders or unitholders of the transferor in exchange for their shares or units would be an assessable distribution within the meaning of subsection 218.3(1) and would be subject to 15 percent tax under part XIII.2. As mentioned, this result is clearly not intended. However, because the timing of the exchange of shares or units of the transferor for units of the transferee is not clearly specified not to be subject to part XIII.2 and is not clearly specified to occur for the purposes of part XIII.2 after the acquisition time when the transferor is deemed not to be a mutual fund corporation or a mutual fund trust, as the case may be, it is impossible to be certain that the exchange will not be subject to part XIII.2.

The Department of Finance stated in the comfort letter that it would recommend to the minister of finance that the Act be amended to ensure that a qualifying exchange occurring after 2004 is not subject to tax under part XIII.2.