On 22 March 2017, federal Finance Minister Bill Morneau tabled his second budget. Contrary to rumours, the budget contained no increase in the capital gains inclusion rate and contained targeted tax measures of interest to financial services organizations (FSOs), namely, banks, insurers and asset managers, as well as their clients.

Targeted measures for FSOs

**Multinational life insurers will now be taxed on Canadian risk in their foreign branches**

Budget 2017 proposes to tax Canadian-resident insurers who insure Canadian risk in an insurance business that is carried on in a country outside Canada (i.e., through a “foreign branch”).

Canadian-resident life insurers are generally taxed on all of their income from a business that is carried on in Canada. However, investment income from a business that is carried on by its foreign branch (i.e., other than income from designated insurance property) would not be taxable in Canada.

Budget 2017 extends the base erosion rules to foreign branches of Canadian-resident life insurers. This new tax measure focuses on Canadian-resident multinational life insurers that have a designated foreign insurance business. A designated foreign insurance business is defined as an insurance business that is carried on by a Canadian-resident life insurer in a country other than Canada where 10% or more of the gross premium income (net of reinsurance ceded) earned by the foreign branch relates to Canadian risk. This new rule deems income from a foreign branch that relates to Canadian risk to be included in the Canadian-resident life insurer’s taxable income.
The federal government has also introduced certain anti-avoidance rules designed to address certain “insurance swap” transactions for a foreign branch of a Canadian-resident life insurer. Similar rules were introduced in Budgets 2014 and 2015 to address “insurance swap” transactions involving foreign affiliates. These rules resulted in income from the insurance of Canadian risk being included in the computation of foreign accrual property income (FAPI).

Under the proposed rules in Budget 2017, if a foreign branch of a Canadian-resident life insurer engages in an insurance swap transaction involving Canadian risk or cedes Canadian risk, the Canadian-resident life insurer would need to include income from the insurance of Canadian risk while computing its income or loss for that taxation year from its insurance business carried on in Canada.

Where a life insurer has insured foreign risk through its foreign branch and it can reasonably be concluded that the foreign risks were insured as part of a transaction or a series of transactions, one of the purposes of which was to avoid the application of the proposed rule, then the life insurer would be treated as if it had insured Canadian risk, rather than foreign risk. This measure applies to taxation years beginning on or after 22 March 2017.

The federal government seems to have imported very similar language from the foreign affiliate rules in their proposed amendments with respect to Canadian life insurers with foreign branches. The overall impact of these amendments on the tried and tested scheme of taxation for multinational life insurers remains to be seen. Whether the federal government has inadvertently created additional complexity by this measure, and the impact on reporting should become clearer in the weeks to come.

Whether these proposed amendments have any impact on the application of Regulation 2400 also remains to be seen. We expect that the final legislation will clarify whether derivatives that mimic Canadian risk or other commercial instruments (ILS) to shift risk were or will inadvertently be caught.

**Tax exemption deemed out of date for insurers of farming and fishing property**

Insurers of farming and fishing property will no longer be exempt from Canadian corporate income tax after 2018.

Under the current tax regime, an insurer of farming and fishing property would be exempt from corporate income tax, if not less than 20% of the total of the gross premium income (net of reinsurance ceded) earned in the period is in respect of the insurance of property used in farming or fishing. This can include the residences of farmers or fishers.

Budget 2017 proposes to eliminate this tax exemption for insurers of farming and fishing property, with this proposed measure applying to taxation years beginning after 2018.

**New stop-loss rule for straddle transactions: impact on non-FIs**

Included with the proposed tax changes in Budget 2017 is a new stop-loss rule that prevents taxpayers from recognizing certain tax losses so as to shelter taxable income that would otherwise arise. While financial institutions (FIs) are exempt from the application of this proposed rule, this proposal has the potential to affect FI clients and ought therefore to be considered in detail by FIs. The proposal should apply to losses realized on transactions that were entered into on or after 22 March, 2017.

The targeted transactions are commonly referred to as “straddle transactions” and, while they’re technically complex, they essentially entail using two concurrent derivative instruments, such as futures
or options. While one instrument generates a loss and the other a corresponding gain, the arrangement effectively shelters income from current taxation.

This may be done by disposing of the loss position (“losing leg”) immediately before a year end, thereby sustaining a loss to be used to shelter other income. At the beginning of the following year, the gain position (“winning leg”) would be disposed of, but this gain would effectively be deferred until the following year. Further, the winning leg may be deferred indefinitely through subsequent straddle transactions.

The proposed rules would deny the loss where there is at that time a “position” that represents an “offsetting position.” An offsetting position is defined as any “position” that has the effect of eliminating the taxpayer’s risk of loss or opportunity for profit or gain on another position. The causal link between the different positions is unclear, particularly as the terms are defined very broadly, and include any property, obligation or liability.

As mentioned, exceptions are provided for FIs. Further, certain hedging transactions are also exempt, as are transactions where a taxpayer holds the offsetting position for a specified period of time. Further, this rule would also not apply where none of the main purposes is to avoid tax nor where the position is a capital property.

Notably, this proposed rule seems to build on last year’s budget, which constrained the use of the “lower of cost or market” method of reporting income with respect to derivative transactions. This method was previously allowed by the Supreme Court of Canada in the context of commodity straddles in Friedberg v Canada.¹

**Derivatives**

**MTM tax treatment of derivatives**

Budget 2017 proposes an elective mark-to-market (MTM) regime for certain derivative transactions. Since FIs are generally subject to the MTM regime, the tax treatment of derivative transactions should come as no surprise, given this has been a long standing administrative position taken on derivatives. For FIs, the key concept is that the application of the elective MTM regime to derivative agreements that are not “tracking property,” where the value is ascertainable, will give certainty to the tax treatment. Should FIs choose not to elect under the proposed rules, the question still exists whether such agreements would still be treated as inventory (assuming they are being treated as inventory now). The proposed rules seem to intentionally leave that particular question open.

Background

The Income Tax Act (the Act) contains very specific rules on the tax treatment of derivative transactions, which has led to some uncertainty in the past. The courts have attempted to provide some clarity, most recently in the Federal Court of Appeal (FCA) decision in *Kruger Incorporated v The Queen*\(^2\). In that case, the FCA found that a taxpayer that was not a FI could use the MTM method to compute its income if the MTM method provided a more accurate picture of the taxpayer’s income.

In line with the decision in *Kruger*, the proposed rules in Budget 2017 confirm that the MTM method may be used for certain “eligible derivatives.” An election may be made by both FIs and non-FIs to treat the eligible derivatives as MTM property. While FIs were always subject to the MTM regime, the new rules provide added clarity with respect to the treatment of eligible derivatives upon the filing of such an election.

**Electing to apply the MTM regime**

Budget 2017 also allows taxpayers to make an election to mark-to-market all of their eligible derivatives. Once made, the election would remain effective for all subsequent taxation years, unless revoked with the consent of the Minister. This election would be available for taxation years that begin on or after 22 March 2017.

As an FI, upon making the election, any “eligible derivative” held in the taxation year would be deemed to be MTM property. For non-FIs making the election, any “eligible derivative” would be deemed to have been disposed of and reacquired at fair market value at that time.

The key aspect to note for FIs is the ability to elect to apply the MTM regime for derivative agreements that are not capital property, where that property can be valued and is not tracking property. The proposed rule would allow FIs to make an election should they so choose.

**What is an “eligible derivative?”**

The proposed rules in Budget 2017 define “eligible derivatives” as a swap agreement, a forward purchase or forward sale agreement, a forward rate agreement, a futures agreement, an option agreement or “similar agreements” provided certain conditions are met.

The latter part of the definition ensures broad application of the proposed rules provided the following conditions are met:

I. The agreement is not capital property, a Canadian resource property, a foreign resource property or an obligation on account of capital of the taxpayer;

II. Either

   a) The taxpayer has produced audited financial statements, or

   b) The agreement has a readily ascertainable fair market value; and

III. Where the agreement is held by an FI, the agreement is not tracking property.

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\(^2\) 2016 FCA 186.
Tracking property is property where the fair market value (FMV) is determined primarily by reference to one or more criteria, such as FMV, profits or gains, revenue, income or cash flow or other similar criteria.

Potential future considerations

The proposed amendments allow for an election to treat all eligible derivatives as MTM property. At this point, there is no ability to opt for different treatment for different derivatives.

Tightening of rules related to de facto control (factual control) and legal enforceability

Among the proposed changes in Budget 2017 is an amendment to the “control” rules, that in considering whether a corporation is controlled “in fact,” the relevant factors to be considered do not need to be legally enforceable.

This change arises from the FCA decision in McGillivray Restaurant\(^3\), where the court affirmed that legal enforceability is a key requirement for a factor to be considered in the analysis of whether a taxpayer controls a corporation, directly or indirectly in any manner whatever. Given that the definition of “control” already bears words of the broadest import, it seems that this proposed change reverses the steps taken by the FCA to limit the broad application of these rules and provides the Canada Revenue Agency (CRA) with considerable leeway in deciding which factors it can rely on in finding factual control. While the law allows an assertion of factual control only where specific words are used, one wonders how long it may be before the CRA uses these “circumstances” to assert some form of common law factual control on assessment.

Financial products

Anti-avoidance rules for registered plans

A number of anti-avoidance rules exist for many tax-assisted registered plans, including tax-free savings accounts (TFSAs), registered retirement savings plans (RRSPs) and registered retirement income funds (RRIFs). These rules are intended to ensure that these plans do not enjoy unreasonable tax advantages. These include:

- The advantage rules, which prevent the exploitation of the tax shelter capacity of a registered plan which could arise from the shifting of returns from a taxable investment to a registered plan;
- The prohibited investment rules, which are intended to ensure that investments held by registered plans are arm's-length portfolio investments; and
- The non-qualified investment rules, which restrict the types of investments that may be held by registered plans.

Budget 2017 proposes to expand these anti-avoidance rules to apply to registered education savings plans (RESPs) and registered disability savings plans (RDSPs) for transactions occurring after 22 March 2017, subject to the following exceptions:

- The advantage rules would not apply to swap transactions undertaken before July 2017 and swap transactions undertaken to ensure that an RESP or an RDSP complies with the new proposed rules

\(^3\) 2016 FCA 99
by removing investments that would otherwise be considered prohibited investments. Further, an investment which gives rise to an advantage would be permitted until the end of 2021.

- Subject to certain conditions, a holder of an RESP or an RDSP could elect by 1 April 2018 to pay Part I tax in lieu of the anti-avoidance rules applying to distributions of investment income from an investment held on 22 March 2017 that becomes a prohibited investment as a result of these proposals.

It is not clear whether there were significant abuses with respect to RESPs or RDSPs, but these new proposals now level the playing field between RESPs, RDSPs and other registered plans.

**Unwinding switch corporations**

Under current mutual fund merger rules, a mutual fund corporation may only rely on the tax-deferred merger rules (qualifying exchange rules) when it merges into a single mutual fund trust. In the case of mutual fund corporations containing more than one class of shares each representing a separate and distinct investment fund (switch corporations), the qualifying exchange rules cannot be used to split apart the switch corporation into separate mutual fund trusts. Such a de-merger of the switch corporation classes of shares outside of these rules is a practical impossibility.

Recent budgets that have been punitive to the tax efficiency of the mutual fund corporation structure, and switch corporations in particular, have brought this deficiency to the fore, which this proposal seeks to address. Effective 22 March 2017, a mutual fund corporation may now merge with more than one mutual fund trust on a tax-deferred basis.

More specifically, the budget proposes to amend the qualifying exchange rules to allow a tax deferred transfer of all or substantially all (i.e., 90% or more) of the property of a mutual fund corporation to one or more mutual fund trusts. This proposed amendment effectively requires the collapse of the entire mutual fund corporation, rather than permitting the selective transfer of classes of shares and the continuation of the mutual fund corporation in reduced form.

For mutual fund corporations with a refundable capital gains tax on hand (RCGTOH) balance at the time of the merger, this tax attribute would be allocated to each mutual fund trust based on the proportion of the total fair market value of property (net of assumed liabilities) received by each mutual fund trust.

**Other specific budget impacts on investment funds**

The proposed straddle rules (discussed previously) do not apply to mutual fund trusts or mutual fund corporations. However, pooled funds, which may hold such positions, would be subject to these proposed rules. With the loss leg being deferred, such an amount would need to be identified, tracked and adjusted in the following year. From a unitholder perspective, this rule may enhance the equitable allocation of taxable income, as the loss and offsetting income would no longer be split into two taxation years, where one investor could benefit at the end of year one (i.e., the loss year) and exit before the gain leg is distributed in year two (i.e., the gain year), with remaining investors (including new investors) being allocated the gain.

Investment funds need to also consider whether to make the proposed mark-to-market derivative election (also discussed previously). For derivative positions established to be on income account, recognizing unrealized gains and losses provides a closer alignment of taxable income with the fund’s accounting.
Accrued gains and losses prior to the election are deferred until realization, creating yet another tax balance to be separately tracked and adjusted.

**Segregated fund mergers**

In 1994, certain initial measures were introduced to allow for the tax-deferred merger of mutual funds. Since that time, the life insurance industry has been seeking similar certainty with respect to the ability to merge segregated funds on a similar tax-deferred basis. Repeated efforts and lobbying by the industry for the introduction of rules that would permit tax-deferred segregated fund mergers did not yield results for more than two decades.

During the intervening period, certain strategies were developed to provide for tax-deferred segregated fund mergers. These strategies were complicated and costly to implement and, as a result, have rarely been used.

Budget 2017 proposes to introduce a regime for the tax-deferred merger of segregated funds modelled largely on the existing rules available to mutual funds. Given the differences between mutual funds and segregated funds, these new proposals would become effective for segregated fund mergers occurring after 2017 in order to give the life insurance industry an opportunity to respond to the proposals, considering the unique operation of segregated funds.

**Segregated fund non-capital loss carryforwards**

A known deficiency in the current tax rules has been the denial of a segregated fund’s ability to carry forward non-capital losses. Such losses are typically the result of management fees exceeding the income earned within the segregated fund, and this issue has become more significant in an era of declining interest rates.

As with the proposed segregated fund merger rules, the life insurance industry has also been seeking rules to address this deficiency.

The proposal involves a subtle change that deems the “taxable income” of the segregated fund for purposes of the trust distribution rules to become payable. The current wording deems the “income” of the segregated fund to become payable from the trust. It is not clear whether this approach resolves the concerns about non-capital losses being lost. As a result, these proposals become effective after 2017 in order to give the life insurance industry an opportunity to respond. Nevertheless, this is good news for the life insurance industry and its segregated fund investors.

A more appropriate proposal might be to allow for the flow-through of the segregated fund non-capital losses similar to the ability of segregated funds to flow-through capital losses. However, it is likely that this option would be denied, as it would create a further difference between segregated funds and mutual funds and the potential for a competitive advantage.
Information reporting matters

The CRA gets more money for audits

Finance reiterated its commitment to fighting tax evasion and improving tax compliance by committing an additional $523.9 million over five years to be used by the CRA to:

- Increase verification activities;
- Hire additional auditors and specialists with a focus on the underground economy;
- Develop robust business intelligence infrastructure and risk assessment systems to target high-risk international tax and abusive tax avoidance cases; and
- Improve the quality of investigative work that targets criminal tax evaders.

Information sharing

The government also highlighted the role of enhanced sharing of information between tax authorities, such as the exchange of financial account information under the Common Reporting Standard. Canada has passed legislation to require the implementation of the Common Reporting Standard effective 1 July 2017, with the first exchange of information with other governments scheduled for 2018.

Budget 2017 goes a step further. The government is looking for a national strategy to improve the availability and collection of information specific to the beneficial ownership of legal persons and legal arrangements. Tax reporting requirements for trusts will receive attention to understand their beneficial ownership. Changes in this area would likely impact how financial institutions currently identify owners of legal entities for purposes of FATCA and CRS.

Electronic distribution of information slips

Filers of information returns, such as T4 and T5 information returns, are generally required to provide two copies of an information slip to each taxpayer to whom it relates. Currently, these copies can only be provided electronically if the recipient has provided express consent in advance. This can result in a significant annual financial cost.

In Budget 2017, the government proposes to introduce rules that would allow employers that meet certain safeguards to provide T4 information slips for 2017 and subsequent calendar years electronically to current active employees without express consent from those recipients. While limited in its application to T4 information slips, this may open the door for broader application to other information returns in future years.

Continued expansion of transfer pricing

Finally, the government has reaffirmed Canada’s commitment to the OECD Transfer Pricing Guidelines as updated through the OECD’s Base Erosion and Profit Shifting (BEPS) project. Taxpayers should be aware of the updates to the Guidelines covering many aspects of transfer pricing, and adjust their transfer pricing policies and documentation accordingly.

The government’s commitment to enforcing the Guidelines is in addition to other BEPS-related initiatives such as the previously announced reporting requirements for taxpayers and promoters to disclose certain avoidance transactions.
The government has also reiterated its commitment to implement measures that Canada agreed to as part of the BEPS project, including country-by-country reporting, automatic information sharing between governments, and the negotiation of a multilateral instrument to implement changes to tax treaties.

Further, a commitment has been made to improve the mutual agreement procedure contained in many of Canadian's tax treaties with its significant trading partners. These new measures should give the CRA access to more information to enable them to carry out more efficient tax audits.

Learn more

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