Lavery CAPITAL

Number 13
December 2016

Legal newsletter to investment fund / venture capital fund managers and investors

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Lawyers
Capital

Changes to the Taxation of Switch Funds

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Effective January 1, 2017, new rules will govern the taxation of mutual fund corporations structured as "switch funds". Investors switching between funds will no longer be able to do so without incurring taxable capital gains. This article summarizes the impact of such changes.

Description of "switch funds" under the current regime

In Canada, most mutual funds are structured as trusts and some are structured as corporations (referred to as "corporate class funds"). The mutual fund trust is comprised of a single fund in which investors receive units of the trust, while the corporate class fund can hold several funds. Each fund is structured as a different class of shares, giving investors access to different investment portfolios of the corporation.

Under the corporate class structure, investors have the advantage of being able to switch between funds without incurring capital gains or losses. This is because the current rules deem switches between funds not to be a disposition of shares of the corporation, resulting in a tax deferral which is not available to investors of mutual fund trusts. Capital gains tax will be paid later upon the future disposition of the corporation's shares.

Impact of the 2016 Legislative Proposals

Effective January 1st 2017, taxpayers switching between funds will be considered to have disposed of their original shares at fair market value and will therefore immediately be taxed on capital gains.

However, the 2016 Legislative Proposals provide for the following two exemptions, allowing tax deferral in these specific cases:

- If the exchange or disposition occurs in the course of a transaction covered by section 86 of the *Income Tax Act* ("**ITA**") or an amalgamation under section 87 ITA, a shareholder will be entitled to a tax deferral provided that: i) all shares of the particular class are exchanged, ii) the original and new shares derive their value in the same proportion from the same property, and iii) the exchange was strictly done for *bona fide* reasons and not to obtain a tax deferral; or
- If shares of a class of the mutual fund corporation are exchanged for shares of the same class, provided that: i) the original and new shares derive their value in the same proportion from the same property, and ii) that class is recognized under securities legislation as a single investment fund.

The above-mentioned changes will be implemented as of January 1, 2017. Therefore, investors wishing to switch shares within a mutual fund corporation have until December 31, 2016 to benefit from the current tax deferral rules.

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