2016 federal budget: impact on investors

April 2016

The 2016 federal budget, released on March 22, contains several items of interest to investors. Some of the proposals provide a limited window of time for investors to take action before the new rules come into effect.

Taxation of corporate class mutual funds

Canadian mutual funds can be in the legal form of a trust or a corporation. While most funds are structured as mutual fund trusts, some are also structured as mutual fund corporations (otherwise known as corporate class mutual funds or 'switch funds').

For those investing outside of their registered plans, one of the key benefits of corporate class mutual funds is their ability to exchange shares of one class of the mutual fund corporation for shares of another class on a tax deferred basis. This allows investors to switch between funds without triggering capital gains or losses. This ability to switch between funds has allowed investors to rebalance regularly without concern for the tax consequences. A capital gain (or loss) does not have to be reported until the holding in the corporation is disposed of.

Proposals announced in the 2016 federal budget will put a stop to this benefit. Exchanges of shares within the corporate class structure that occur after September 2016 will be considered a fair market value disposition for tax purposes. This will eliminate the tax deferral and trigger a capital gain if the investment has risen in value at the time of the switch. This measure will not apply if the switch is made into a different series of shares within the same class.

If you hold corporate class mutual fund investments as part of your non-registered portfolio, consider reviewing your holdings and making any strategic asset allocation changes before the end of September 2016.

Sale of linked notes

Linked notes are debt obligations where the return on the note is linked to the performance of one or more reference assets or indexes.[1]

[1] For example, a basket of stocks, a stock index, a commodity, a currency or units of an investment fund.

Due to its structure, the investment return on the note is constantly in flux and can usually only be determined shortly before it matures. As a result, under current rules, the return on such a note is taxed as interest income if the note is disposed of at or near maturity, but as a capital gain if it is sold prior to that time. To facilitate this planning, issuers of linked notes often establish a secondary market where investors can sell their linked notes prior to maturity to an affiliate of the issuer. This effectively converts the return on the notes from ordinary income to capital gains, only 50 percent of which are taxable.

The federal budget has introduced a deeming rule that will treat any gain[2] 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. This change eliminates the opportunity to convert interest income into capital gains by selling a linked note prior to maturity.

This measure will apply to dispositions of linked notes that occur after September 2016. Typical terms of linked notes are five or seven years. Current holders of linked notes will need to review their holding to determine if it still makes good sense on the investment side. If it becomes fully taxable, is it still a viable investment or would it be better to dispose of the investment before the end of September 2016 and buy something else?

Labour-sponsored venture capital corporation (LSVCC) tax credits

A labour-sponsored venture capital corporation (LSVCC) is a fund managed by investment professionals and invested in small to mid-sized Canadian companies. The federal government and some provincial governments offer tax credits to LSVCC investors to promote the growth of such companies.

Prior to 2015, individuals acquiring LSVCC shares qualified for a 15 percent federal tax credit for investments of up to $5,000 each year. However, measures had been introduced to gradually phase out this credit to 10 percent for the 2015 taxation year, five percent for the 2016 taxation year and then eliminated for the 2017 and subsequent taxation years.

The 2016 federal budget proposes to reinstate the 15 percent credit for share purchases of provincially-registered LSVCCs[3] for 2016 and subsequent years.[4]

Although the 15 percent tax credit offers a generous incentive to invest (and may be accompanied by provincial tax credits), remember that you need to be comfortable with the underlying investment as well.

Mineral exploration tax credit

Flow-through shares allow resource companies to renounce or "flow-through" tax expenses associated with their Canadian exploration activities to investors, who can then deduct the expenses in calculating their own taxable income. Since junior mining companies tend to have little or no revenue, they often "renounce" their claim to exploration expenses.

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[2] When a linked note is denominated in a foreign currency, foreign currency fluctuations will be ignored for the purposes of calculating this gain.
[3] That meet certain prescribed conditions under the Income Tax Act
[4] The credit will still be phased out by 2017 in respect of federally registered LSVCCs.

The mineral exploration tax credit provides an additional tax benefit for individuals investing in resource flow-through shares. This credit can be claimed by individuals who invest in flow-through shares, equal to 15 percent of specified mineral exploration expenses incurred in Canada and renounced to flow-through share investors.

The credit was scheduled to expire on March 31, 2016. The budget proposes to extend the credit for an additional year, to flow-through share agreements entered into before April 1, 2017 and in respect of eligible expenses incurred until the end of 2018.

Donation of real estate and private company shares

The 2015 federal budget had included a proposal to provide for a capital gains tax exemption on certain dispositions of private company shares or real estate, where cash proceeds from the disposition are donated to a registered charity or other qualified done within 30 days of the sale. This measure was to be effective for donations in 2017 and subsequent years. The 2016 federal budget announced that the government will not be proceeding with this measure.

If you would like to learn more about these changes or any of the other measures announced in the 2016 federal budget, please consult with your tax advisor.

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