International Competitiveness in Asset Management

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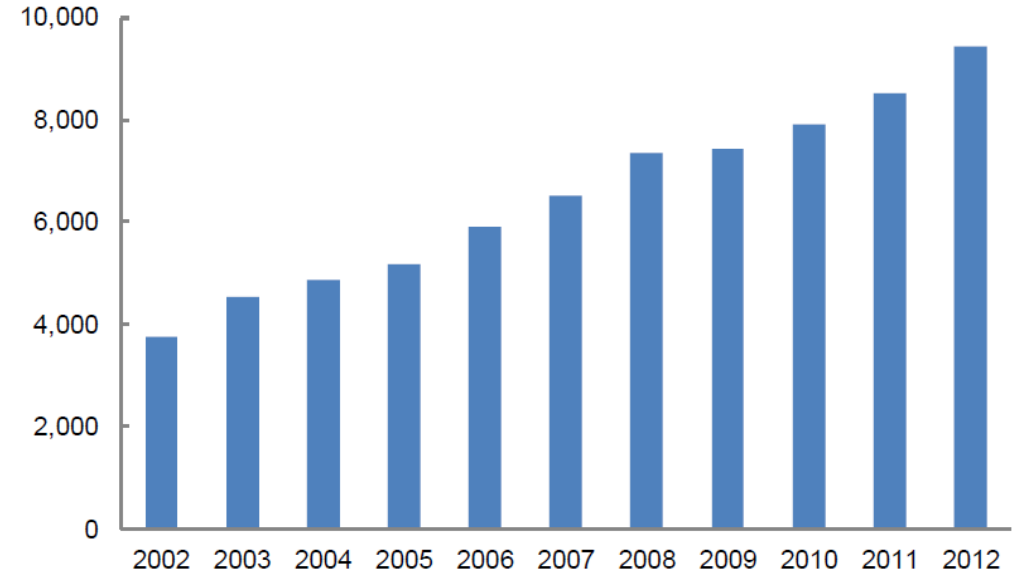
GLOBALIZATION IN ASSET MANAGEMENT

Number of Worldwide Cross-Border Funds

Year-end, 2002–2012



Sources: Lipper LMI and PwC

KEY INDUSTRY CHANGES

- Consolidation of fund companies
- Development of funds aimed at attracting non-resident investment – e.g.
  - Corporate funds
  - Contractual funds

IFIC'S SUBMISSION TO DEPARTMENT OF FINANCE

- In May, IFIC met with officials in Ottawa to discuss the need for tax proposals aimed at improving the competitiveness of Canadian asset managers
  - Canada's "safe harbour" rule for the taxation of foreign funds
  - Taxation of non-resident investor in Canadian collective investment vehicles ("CIVs")
- IFIC provided information to officials on the globalization of the industry and initiatives in other jurisdictions
  - e.g. Australia, U.K., Singapore

U.K.'S TAXATION OF FOREIGN FUNDS WITH DOMESTIC ASSET MANAGERS

- The U.K. has introduced rules to reduce the potential U.K. taxation of non-U.K. "foreign" funds due to the provision of services by U.K. residents
- The U.K. Investment Management Exemption is aimed at encouraging growth in their industry
  - According to HMRC, it ensures that:
  1. overseas investors are not charged U.K. tax, and
  2. fees received by a UK resident investment manager for services performed for the non-resident are fully chargeable to UK tax

U.K.'S PRODUCT INNOVATIONS

- Importance of European regulatory regime
  - "Passporting" for distribution of funds
- Flexibility of corporate form
  - Authorised unit trusts
  - Open-ended investment companies (OEICs)
  - Authorised contractual scheme
- Modernization of the tax rules
  - Consistent treatment of trusts and companies
  - Contractual structure designed as a flow-through

CANADA'S SAFE HARBOUR RULE

- Canada's safe harbour rule is drafted to provide certainty to foreign funds using Canadian service providers - however, it's limited, particularly as compared to the rules in other jurisdictions
  - Makes it difficult to compete
- Limitations:
  - Prohibition against Canadian investors, where Canadians provide investment management services
  - Definition of "qualified investment"
  - Limitation on affiliated persons and seed capital
  - List of designated investment services

CANADA'S FUND STRUCTURES

- Canadian mutual funds are typically structured as trusts
  - Mutual fund corporations, LPs, segregated funds
- Fundamentally designed for Canadian investors
  - Mutual fund trusts require year-end distributions be made to investors which can attract non-resident withholding tax and reduce investor returns

REQUEST TO THE DEPARTMENT OF FINANCE

1. Expand the investment management safe harbour
   - Eliminate the prohibition against Canadian investors
   - Expand definition of “qualified investment”
   - Remove or amend the limitation on affiliated persons
   - Extend the one year seed capital period
   - Extend the list of designated investment services
2. Improve Canadian fund structures so they work for investors outside Canada
   - Eliminate withholding tax in certain instances, or
   - Allow other types of structures (e.g. provide tax transparency)

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NEXT STEPS

- IFIC has been engaged in discussions with Finance on next steps including how any possible tax changes will dovetail with securities laws in this area
- We would appreciate engagement with regulatory colleagues!

Derivatives -Timing Issues

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INTRODUCTION

Presentation today has 2 parts:

- *Kruger* case and computation of income under s. 9
- Proposed MTM regime for “eligible derivatives”. Key takeaway is that investment fund that relied on CRA administrative practice to use MTM on speculative derivatives will need to consider making election

TIMING

- The time at which gain or loss on a derivative is recognized depends on whether it is on income or capital account. The presentation today addresses derivatives on income account i.e., speculative derivatives.
- For “FIs” as defined in 142.2(1), MTM regime applies to derivatives that are “tracking property”. CRA has allowed FIs to use MTM in relation to non-MTM property.
- Similarly CRA has allowed investment funds to elect to use MTM on speculative derivatives (Technical News 14)
- For other taxpayers CRA’s position was that MTM was not acceptable under s.9

TIMING - S.9

- Canderel set out framework for computation of income under s.9:
  - determination of profit is a question of law
  - goal is to obtain an accurate picture of the taxpayer's profit for the given year
  - the taxpayer is free to adopt any method which is not inconsistent with
    - the provisions of the Income Tax Act
    - established case law principles or “rules of law”; and
    - well-accepted business principles-”interpretive aids”
  - once taxpayer shows he has provided an accurate picture of income, onus shifts to Minister to establish a more accurate method

GAAP

- IFRS and ASPE: default rule:
  - all derivatives are recorded at their fair value when entered into
  - changes at balance sheet date are carried to the P&L
- IFRS and ASPE: can elect hedge accounting if a qualifying hedge

KRUGER (FACTS)

- Kruger's principal business a paper manufacturer
- Had established a separate business of speculating in foreign currency options
- Market for foreign currency options fully liquid
- Derivatives in issue:
  - Written options in Year 1 matured in Year 2
  - CAD had fallen against USD
  - At y/e, had negative value - $91 million loss
- Result for f/s purposes: MTM basis - $91 loss
- Result for tax purposes: realization basis – no loss

KRUGER (ACCOUNTING EVIDENCE)

- Expert accounting evidence that MTM appropriate because:
  - Measurement reflected amount for which derivative could be settled at y/e
  - MTM best measure of the result of the speculative decision to write the option
- However, realization could be used where high degree of uncertainty to make reasonable estimates required by accrual accounting

KRUGER (ISSUES AND TCC DECISION)

- CRA:
  - Asserted that realization principle was a rule of law
  - Overrides other principles
- Taxpayer:
  - Realization is not mandatory
  - MTM is a well-accepted business principle
- Tax Court of Canada.
  - Realization a fundamental principle of income computation
  - Absent a provision of the ITA to the contrary, application of the realization principle is required

FCA (REASONS)

- Realization not an “overarching principle”; 1962 SCC case *Canadian General Electric* held that taxpayer was entitled to use either MTM or realization
- Expert accounting evidence: MTM produces an accurate depiction of profit from speculating in derivatives
- No evidence to show that realization produces a more accurate depiction of profit
- No contrary ITA provisions or rules of law

FCA (CONCLUSION)

- Conclusion – that MTM produces "*as accurate"* a picture of profit as realization would provide
- Surprising statement given that
  - unanimous view of accounting experts that MTM is only acceptable method of computing income from derivatives for accounting purposes
  - No evidence relating to the accuracy of the realization method in computing income from derivatives
- Remains open to taxpayer to choose the realization method as accounting evidence Minister may adduce in support of MTM method will not be sufficient for court to find that the MTM method is "more accurate"

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BUDGET 2017

- Budget 2017 contained proposed legislation for an elective MTM regime in new s.10.1
  - Minor revisions in draft legislation released September 8, 2017
  - Available to taxpayers whose “eligible derivatives” are not capital property (or an obligation on capital account)
  - Applies to both FIs and non-FIs
  - Although elective, there is a stick:
    - s10.1(8)-in the case of a non-FI, if taxpayer doesn’t elect, it can’t use a method of profit computation that produces a substantially similar effect to MTM method—left with realization? Investment funds that are not FIs and that relied on CRA administrative policy to use MTM should make election.
  - Election can only be revoked with concurrence of Minister who may specify terms and conditions
    - Revocation applies to taxation years beginning after Minister concurs
    - Possible to elect again after revoking an election but the new election only applies to taxation years beginning after the day the new election is made

ELIGIBLE DERIVATIVE

- A swap agreement, a forward purchase or sale agreement, a forward rate agreement, a futures agreement, an option agreement or a similar agreement held at any time in taxation year
- Can’t be capital property, a Canadian resource property, a foreign resource property or an obligation on account of capital
- Either
  - Taxpayer has produced audited F/S in accordance with GAAP, or
  - If taxpayer does not produced such audited F/S, derivative has a readily ascertainable fair market value
- If taxpayer an FI, property is not a “tracking property” other than an “excluded property”

EFFECT OF ELECTION

- FI
  - each eligible derivative held by the taxpayer at any time deemed to be *mark-to-market property* as defined in subsection 142.2(1)
- Non-FI
  - S. 10.1(6) applies
    - Each eligible derivative held at end of year deemed to have been disposed of immediately before end of year and taxpayer deemed to have received or paid FMV
    - Taxpayer deemed have reacquired, or reissued or renewed, the eligible derivative at the end of the year at an amount equal to the proceeds or the amount, as the case may be

EFFECT OF ELECTION-TRANSITIONAL YEAR

- Taxpayer holds eligible derivative at beginning of election year and in prior year did not use a method substantially similar to MTM [e.g., an investment fund that relied on CRA administrative policy to use realization]
- Preceding year
  - Immediately before beginning of election year, deemed to have disposed of it and received proceeds or paid an amount, as the case may be, equal to FMV
  - Profit or loss deemed not to arise in such preceding year but rather when there is an (actual) disposition of the derivative
- Election Year
  - Deemed to have reacquired, or reissued or renewed, the eligible derivative at the start of the year at an amount equal to the deemed proceeds or amount paid

MISCELLANEOUS RULES

- Eligible derivative that is not property (because it is an obligation)
  - taxpayer deemed to hold the eligible derivative at any time while a party to the agreement
  - taxpayer deemed to dispose of the eligible derivative when it is settled or extinguished
- Budget proposed that an eligible derivative can't be transferred under s. 85(1), 85(2) or 97(2) but this rule is not in September draft legislation
- Rules apply to taxation years beginning after March 21, 2017

Invesco and MacDonald Cases

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INTRODUCTION - INVESCO

- Tax Court of Canada (“TCC”) decision from May, 2017 currently on appeal to the Federal Court of Appeal.
- Appellant has filed its Factum and Crown’s Factum due next month.
- Case is about GST on deferred sale charge (“DSC”) financing transaction undertaken by retail mutual funds (“Funds”) with Citibank.
- TCC held that GST was exigible on the consideration paid to securitization party that provided money used to pay the commissions for DSC securities.

INTRODUCTION – INVESCO (CONT'D)

- Funds had self-assessed GST on Earned DSC Fees and then claimed rebates to recover the tax.
- Rebates were disallowed.
- CRA further assessed GST on Earned Daily Fees that had not previously been self assessed.
- Funds appealed to the TCC to recover rebates and have assessment for additional tax set aside.

FACTS FOUND BY TCC - INVESCO

- Funding Corp. (a U.S. company in the Citibank group) agreed to and did provide over $600 million to the Funds that were managed by the Invesco (the “Manager”).
- The Funds offered its units on a DSC basis.
- The Funds were growing and needed financing.
- The more investors invested under the DSC option, the more money was needed to pay the brokers who originated such units.
- Limitations in law on how brokerage commissions could be financed.
- Until 2002, the Manager funded all DSC Commissions out of its own pocket, but did not have the ability or desire to continue to do so as the Funds grew. As a result, the Funds sought a securitization financing for the Funds from a third party source.

FACTS FOUND BY TCC – INVESCO (CONT'D)

- Under the financing transaction:
  - Funding Corp. delivered immediately available funds on a daily basis needed to pay commissions to brokers on purchases of securities issued by the Funds.
  - In exchange, Funding Corp. was entitled to consideration which consisted of the right to receive Earned Daily Fees (which were based on a percentage of the value of the securities of the Funds) and Earned DSC Fees (which were in an amount equal to the Investor DSC Payments).

FACTS FOUND BY TCC – INVESCO (CONT'D)

- Justice Miller had to consider whether the provision of financing by Funding Corp. was an "imported taxable supply".
- At paragraph 95 of her decision, Justice Miller found that the dominant element of the financing transaction was the provision of the daily payment of the amounts used to fund DSC Commissions "with immediately available funds". At paragraph 96, Justice Miller held that money is not a supply but did not find that determinative.
- Justice Miller also found that the financing transaction at issue was a "single supply" and not a multiple supply of separate constituent elements.

KEY FINDINGS OF THE TAX COURT - INVESCO

- At paragraph 89 of her reasons, Justice Miller described what she viewed that the services were:

  i. Funding Corp provided a service “in arranging for the funding of the Funding Amounts”. Both paragraphs 2.03(d) and 2.04(e) of the Fee Payment Agreement include the following sentence:

> “…the Earned Fees are fees paid by the Funds for services to the Funds rendered by Funding Corp in the United States in arranging for the funding of the Funding Amounts…”(emphasis added [in original]).

KEY FINDINGS OF THE TAX COURT – INVESCO (CONT'D)

ii. On a daily basis, Funding Corp was responsible to receive, process and transmit (or cause to be transmitted) the Funding Notices it received from the Manager to Citibank, Citicorp and the Collection Agent. It effected this service by causing the Funding Notices to be transmitted by the Manager to Citibank, Citicorp and the Collection Agent.

iii. On a daily basis, Citibank deposited the Funding Amounts in the Dealer Commission Trust Accounts

KEY FINDINGS OF THE TAX COURT – INVESCO (CONT'D)

- Notwithstanding that Justice Miller found that "the dominant element of the single supply was the daily payment…with immediately available funds". She went on to consider whether Funding Corp. supplied a "financial service" within the definition of s. 123(1) and concluded that it did under (a) (subject to her analysis of the (q) exception).

KEY FINDINGS OF THE TAX COURT – INVESCO (CONT'D)

- Justice Miller determined that paragraph (q) applied, and the supply was therefore not a "financial service" primarily because the Manager had previously provided funds used for the purpose of funding DSC Commissions and "arranging for the payment" of commissions and the payment of commissions was a part of operations of the Funds and a management duty. The Tax Court concluded that the Citibank entities carried out a management duty that was "delegated" to them by the Manager (para. 105).

KEY FINDINGS OF THE TAX COURT – INVESCO (CONT'D)

- As a result, Justice Miller held that Funding Corp. did not provide a "financial service" because it was providing a management service for an investment plan. In her view, the Funds were, therefore, not exempt from paying GST on the consideration paid to acquire the Funding Amounts.
- At paragraph 104 of her decision, the learned Judge held that because the Manager had arranged for the funding of DSC Commissions both before and after the period in issue and because the Manager had the duty to manage the Funds' business, the provision of financing of commissions was part of the day-to-day operations of the Funds and was, therefore, a management service under paragraph (q) of the definition of "financial service".

BASIS FOR APPEAL - INVESCO

- Providing money is not a supply.
- Alternatively, paragraph (q) does not apply.
  - The TCC did not properly consider the meaning of management or administrative service and failed to properly apply the applicable meanings consistent with the learned judge's findings of fact. If, as the appellants submit, Funding Corp. did not provide a management or administrative service to the Funds, the supply does not meet the test in paragraph (q) for that reason alone.

BASIS FOR APPEAL – INVESCO (CONT'D)

In the alternative, even if Funding Corp. provided a management or administrative service, it still does not meet the requirements of paragraph (q). TCC did not comment on the closing language of paragraph (q), which focused on the nature of the supplier. It requires as a precondition that "the supplier" be "a person who provides management or administrative services to the investment plan, corporation, partnership or trust". There must be a management or administrative service supplied by the supplier in addition to the funding transaction that has been found to meet the requirements of paragraphs (a) to (m). Funding Corp. was a financial entity, not an investment plan manager. It was a money supplier. It was not engaged to manage the funds.

INTRODUCTION - MACDONALD

- TCC decision, August 8, 2017.
- TCC held that certain settlement payments made on Forward Contract for sale of BNS securities were on income account.
- Crown argued that taxpayer used Forward Contract to hedge his holding of BNS shares and that losses from Forward Contract were on capital account.

FACTS FOUND BY TCC – MACDONALD (CONT'D)

- Taxpayer had over 40 years experience, including senior positions at McLeod Young Weir ("MYW") and later Scotia McLeod.
- He sold shares of MYW in 1988 and acquired 183,333 BNS shares.
- In the late 1990s, taxpayer anticipated that BNS shares would decline in value and entered into a Forward Contract with TD. The Forward Contract could only be cash settled.
- Taxpayer's BNS shares were pledged.

FACTS FOUND BY TCC – MACDONALD (CONT'D)

- In 1997, TD agreed to loan up to $10,477,480 secured by BNS shares of Forward Contract.
- Loan advance was $4,894,000 but had declined to $554,485 by 2004.
- Market was down in 1988, but taxpayer did not realize a gain in Forward Contract.

FACTS FOUND BY TCC – MACDONALD (CONT'D)

- TCC found that Forward Contract was speculative and that was an adventure or concern in the nature of trade.
  - Sole purpose and intention was to speculate and profit from decline in BNS share price.
  - Cash settlement aspect confirmed the trading/speculative aspect.
  - Taxpayer did not consider the loan and security agreements as being part of Forward Contract.
  - Taxpayer did not intend to sell BNS shares

FACTS FOUND BY TCC – MACDONALD (CONT'D)

- Second step was to analyze hedge.
  - Hedge is a strategy to offset risk.
  - Central to hedge is:
    i. intention to eliminate risk;
    ii. hedging instrument is directly linked to underlying asset that is subject to the hedge both as to quantum and timing.

FACTS FOUND BY TCC – MACDONALD (CONT'D)

- Court found – no intention to hedge BNS shares because hedge was cash settlement.
- As long as taxpayer did not sell the shares, he was not exposed to risk.
- Notional value of Forward Contract was less than total BNS shares.