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2004 Budget Proposals Relating To Income Funds

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The 2004 federal Budget, announced on March 23, 2004, contains several tax proposals that are relevant to Canadian income funds and their pension fund and non-resident investors. A general summary of these proposals is set out below.

Limitations on Pension Fund Ownership

The government expressed the concern that unlimited participation of pension funds in the business income trust market could have a significant impact on the market and government revenues because of their tax-exempt status and their influence in Canadian capital markets. In response to this concern, the Budget proposes two measures restricting investment by pension funds in business income trusts.

Scope of Limitations

The proposed limitations apply to registered pension plan trusts, registered pension plan corporations, tax-exempt investment corporations and the Canada Pension Plan Investment Board. The proposals do not apply to RRSPs, other tax-exempt investors or funds of funds.

As discussed below, the limits will apply to holdings of units of a "business income trust"[1] or other "restricted investment property". "Restricted investment property" includes not only units and debt of a "business income trust", but also (i) interests in certain other entities that hold more than 1% of their property in restricted investment property (e.g. a fund of funds) and (ii) property the fair market value of which is determined primarily by reference to restricted property.

1% of All Property

Under the Budget proposals, a pension fund's holdings of restricted investment property will be limited to 1% of all of the pension fund's property (based upon cost amount). If a pension fund holds restricted investment property in excess of the 1% limit at the end of a month, it will be subject to a penalty tax for the month equal to 1% (i.e. 12% annually) of the cost amount of the excess restricted investment property.

5% of Units of a Business Income Trust

In addition, a pension fund (together with non-arm's length persons) will be limited to holding no more than 5% of a class of units of a particular business income trust (based upon fair market value) at the end of any month. If a pension fund exceeds this limit for a particular month, it would be subject to a tax for the month equal to 1% (i.e. 12% annually) of the fair market value of the excess investment.

Application and Grandfathering

The new penalty taxes are applicable after 2004. However, the Budget contains grandfathering rules that permit pension funds to hold free of the penalty taxes (i) up to and including 2013, any units or debt in a business income trust that were held continuously since the March 22, 2004 and (ii) up to and including 2008, any other restricted investment property held continuously since March 22, 2004, even if such holdings would otherwise cause the holding restrictions to be exceeded.

The Department of Finance indicated that it will continue to monitor the development of the income trust market as part of its ongoing monitoring and assessment of both the Canadian financial market and the Canadian tax system.

Taxation of Distributions to Non-Residents

In order to address concerns that non-resident investors in a mutual fund are not currently subject to Canadian tax on their portion of gains realized by the mutual fund on "taxable Canadian property",[2] the Budget proposes to extend the

[1] For these purposes, a "business income trust" will generally be a unit trust, any unit of which is listed on a prescribed stock exchange, where 50% or more of the value of the trust's property is attributable to debt or participating interests in entities in which the trust (and persons with whom the trust does not deal at arm's length) own 10% or more of the participating interests in the entity determined on a fair market value basis. However, a trust will not be a business income trust if more than 90% of the fair market value of a trust's property is derived from certain prescribed properties (including real property, debt secured by real property, Canadian or foreign resource property, timber resource property, certain publicly listed shares and debt, certain government indebtedness, and property more than 90% of the fair market value of which is derived from such prescribed properties).

[2] "Taxable Canadian property" includes, among other things, Canadian real estate, shares in private Canadian corporations, interests in a partnership the value of which is primarily attributable to taxable Canadian property.

existing non-resident withholding tax to distributions of such gains by a mutual fund to a non-resident. The Budget also introduces a 15% withholding tax on distributions made by certain mutual funds to non-residents that would otherwise not be subject to Canadian tax. Because income funds are generally structured as mutual fund trusts, these measures will affect income funds and their non-resident unitholders.

Withholding Tax on Distribution of TCP Gain

The Budget proposals require every mutual fund to maintain a "TCP gains distribution account" to reflect gains realized by the mutual fund from the disposition of taxable Canadian property. In the case of a mutual fund trust, such gains, if designated as capital gains to a non-resident unitholder, would not under current law be subject to withholding tax. The Budget proposes to make such distributions subject to the 25% withholding tax applicable to trust distributions under Part XIII of the Income Tax Act. Similar rules would apply to treat distributions of gains on taxable Canadian property by a mutual fund corporation to a non-resident as a taxable dividend (rather than a capital gains dividend), which would give rise to withholding tax at the domestic rate of 25%. In each case, the 25% rate of withholding may be reduced to 15% under the provisions of an applicable tax treaty.

This proposal applies in respect of dispositions of taxable Canadian property that occur after March 22, 2004.

Withholding Tax on Tax-Deferred Distributions

Currently, tax-deferred distributions (i.e., distributions of sheltered cash) by a mutual fund trust to a non-resident are not subject to Canadian withholding. While the amount of such distributions will reduce the adjusted cost base of the units held by the non-resident investor, such investor is not typically subject to Canadian tax on the disposition of its investment. Under the Budget proposals, distributions made by certain mutual funds (generally REITs and royalty trusts listed on a prescribed stock exchange) to non-resident investors will now be subject to a 15% withholding tax to the extent such distributions would not otherwise be taxable (i.e. distributions of sheltered cash). If the non-resident investor subsequently realizes a loss on the disposition of the unit or share of the mutual fund, such losses may be carried back 3 years or carried forward indefinitely to offset the distributions subject to the new withholding tax enabling the non-resident to claim a refund of some or all of the withholding tax paid.

This proposal applies after 2004.

Limitation on Investment by Mutual Funds in Resource Properties

Under the current rules, if more than 10% of a mutual fund's property consists at any time of taxable Canadian property and the mutual fund is established or maintained primarily for the benefit of non-residents, the fund may lose its status as a mutual fund trust or mutual fund corporation. The Budget proposes to clarify that for purposes of computing the 10% threshold, Canadian resource property and timber resource property will be treated as taxable Canadian property. This measure is to apply after March 22, 2004 unless the mutual fund would lose its status on March 23, 2004 as a result of this measure, in which case this measure will not apply until 2007.

We invite you to contact any of the following tax lawyers from our REITs and Income Funds Group to discuss this year's budget proposals relating to income funds.

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