MACKENZIE Investments | CONFIDENCE IN A CHANGING WORLD

Mutual Fund Mergers

10 Strategies for Reducing Taxes on Realized Capital Gains in Non-Registered Accounts

From time to time, investment managers need to merge funds to simplify the product shelf, reduce overlapping investment objectives and take advantage of economies of scale. In many cases, a taxable event occurs when a terminating fund is merged into a continuing fund. As a result, investors (individuals, corporations, or trusts) owning the terminating fund may experience a capital gain at the time of the merger, if the investment has appreciated in value.

General tax treatment on capital gains

Capital gains arise when a property with an appreciated value is sold or deemed to be sold (I.e. some fund mergers). Under current rules, 50% of the capital gain is subject to tax. The other 50% portion is not taxable. For this reason, capital gains generally attract the lowest rate of taxation compared to other types of income in Canada.

Investors facing income taxes due to the fund mergers may consider the following tax strategies to assist in reducing or eliminating the tax liability.

1) Sell to a related adult family member for demand loan and promissory note payable over a 5-year term

Before the merger, consider selling the investment at fair market value to a related adult family member such as a spouse, common law partner or an adult child in exchange for a promissory note due on demand at CRA-prescribed interest rate (2% at the time of writing). Structured properly, this strategy allows the capital gain to be spread equally over a maximum 5-year period, hence deferring and possibly reducing the total taxes paid by the investor.

2) Incorporated business owners

Before the fund merger, incorporated business owners with available capital losses in their corporations may consider transferring personally held appreciated securities subject to the fund merger to utilize the loss in the corporation. To accomplish this on a tax-deferred basis, the individual shareholder can transfer their mutual fund portfolio at their tax cost to the corporate entity by electing under subsection 85(1) of the Income Tax Act (ITA). This way, capital gains realized on the merger are recognized in the corporation and the corporate losses are used to reduce the capital gain triggered by the fund merger. A few factors impact this decision, including;

- The investor's personal effective tax rate in comparison to the corporation's tax rate
- The new small business limit reduction when aggregate investment income exceeds a certain threshold
- May need to consider the new income sprinkling rules

3) Charitable Donations

Charitable donations provide tax savings in the form of charitable donation tax credits (donation receipt equals fair market value of property donated), available both federally and provincially. Also, donating certain mutual funds in-kind are subject to a 0% capital gain inclusion rate as opposed to the standard 50%. It is best to donate the securities in-kind before the fund merger. This way, the capital gains are fully tax exempt. Although the donation tax credit is available pre- and post-fund merger, there is likely to be minimal to no capital gain if the donation in-kind is made after the merger, as the investor is deemed to reacquire the new fund at the fair market value of the merged fund. At the time of the merger the fair market value equals the adjusted cost basis. Investors (except alter ego and joint partner trusts) who are philanthropic, or planning to give money to charity soon, may accelerate the tax benefits by donating to charity in the year of a fund merger.

Specifically, investors could utilize a donor advised fund, such as the Mackenzie Charitable Giving Program to obtain the tax benefits, as well as achieve a more strategic approach to fulfilling philanthropic objectives. A donor advised fund (DAF) allows Canadians to make an up-front donation to a charitable foundation, obtain the immediate tax savings and keep the funds invested within the foundation to grow over the long-term. Going forward, the donor provides direction as to how to distribute income or capital to the donor's charities of choice on an annual basis.

4) Consider reducing controlled income

Investors who have a degree of flexibility or control in their income may consider the following strategies to lessen the tax impact due to the fund merger.

- Shareholders of private corporations may consider a reduction in salary or taxable dividends
- Individuals eligible for CPP this year may consider deferring benefits until next year
- Seniors who qualify for pension income splitting may split qualified income to the lower income spouse (subject to the 50% maximum)
- Reduce or defer RRSP withdrawals
- Structuring proceeds on disposition or other payments to be payable over more than one tax year

5) Review investments in a capital loss position

Triggering capital losses on investments that have declined in value can provide tax savings. Generally, capital losses can only be used to offset capital gains. Specifically, capital losses can be used to reduce capital gains realized in the current year, carried back three taxation years, or carried forward indefinitely and applied against future capital gains. Triggering capital losses towards the end of the calendar year allows investors with realized taxable capital gains due to the merger to match those gains against capital losses to reduce or eliminate income taxes.

If individual investors plan to repurchase the same or similar investment, they will need to be aware of the superficial loss rules in the ITA. If caught by these rules, the individual investor's capital loss will be denied and cannot be used to offset the capital gain.

A superficial loss occurs when an individual investor sells a capital property at a loss and the same or identical property is acquired by the individual, or an affiliated person (including a spouse, common law partner, RRSPs and TFSAs owned by the investor, to name a few), during the period beginning 30 calendar days before the sale and ending 30 calendar days after the sale, and, at the end of that period, the individual or the affiliated person continues to own the same property. If this occurs, the capital loss is deemed to be a superficial loss. While the capital loss is denied immediately, it is not lost forever. The denied loss is added to the ACB of the newly acquired investment. The capital loss or reduced capital gain will be realized in the future from the addition to the ACB when the investment is sold.

6) Apply unused capital losses carried forward from previous years

Investors with capital losses carried forward from prior taxation years may apply those losses against the current year capital gains due to the fund merger. Check the latest CRA Notice of Assessment to determine whether any unused capital losses are available.

7) Transfer unrealized capital losses to a spouse or common law partner

If an investor does not have capital losses (realized or unrealized) available to offset capital gains, but the investor's spouse or common law partner has unrealized capital losses in their portfolio, there is a way to transfer unrealized capital losses to a spouse, who may then apply the losses against the capital gain triggered on the fund merger. This strategy is done in 3 steps, best illustrated by an example.

Example:

Ben owns units of XYZ mutual fund with a current market value of $10,000. He purchased this investment many years ago for $20,000, which represents his ACB. Therefore, Ben has an unrealized capital loss of $10,000. His wife, Sophia owns an investment with a $10,000 accrued capital gain. She received a notice that her investment will be merged into another fund on a taxable basis, meaning she will realize and report the $10,000 capital gain on her tax return. In this example, Ben can transfer his $10,000 unrealized capital loss to Sophia. By doing so, Sophia, can apply Ben's losses against the capital gain triggered on the fund merger, thus eliminating the tax liability. Here's how Ben and Sophia implement this strategy:

Step 1: Ben sells units of XYZ fund.

Ben sells his XYZ mutual funds for fair market value at $10,000. This will trigger his $10,000 capital loss.

Step 2: Sophia purchases units of XYZ fund

Immediately after step 1 (or sometime within 30 days), Sophia purchases the same investment (XYZ mutual funds). Assume Sophia pays $10,000 to purchase the same investment immediately after step 1. The superficial loss rule will apply and deny Ben his $10,000 capital loss. However, the amount of capital loss is then added to the ACB of Sophia's newly acquired investment. Sophia's new ACB will be $20,000 (the $10,000 she originally paid, plus the $10,000 superficial loss added to the ACB).

Step 3: Sell the investment 30 days after the settlement date from Step 1.

After 30 days from Ben's settlement date, Sophia will sell her investments. For simplicity, assuming the investments market value remains at $10,000, she will trigger a $10,000 capital loss. Sophia may then apply the capital loss against the capital gain and eliminate any tax liability caused by the taxable fund merger.

Note: Short term trading fees may apply to these transactions

8) Maximize RRSP contributions

Contributions made to an RRSP are tax deductible against all sources of income (including capital gains arising from the fund merger), reducing taxable income and taxes owing. Individual investors should review their available RRSP contribution limits with their financial advisors and determine the suitability of this strategy to help offset the tax liability from the taxable fund merger.

9) Deductions

Usually, an expense incurred by the taxpayer to gain or produce income from the business or property is deductible, so capital gains can be reduced by expenses incurred to earn property income reducing the tax impact. An example may be interest costs incurred to earn income, such as a leverage loan to purchase investments or other income producing assets.

10) Consider personal situation

An investor's personal situation may offer other potential deductions. For example, the investor may have moved residences, changed marital and employment status, or had children. Review the Mackenzie Investments year-end tax-planning guide for additional strategies to consider.

The above strategies are general in nature. Investor need to consult with their tax professional and/or accountant to determine whether any of the above strategies are applicable in their situation.

This should not be construed to be legal or tax advice, as each client's situation is different. You should consult your own legal and tax advisor before taking any action in contemplation of a proposed merger or reorganization.

213797 6/18

MACKENZIE Investments