

government releases revised transitional rules for 2013 "character conversion" measures

background

In the 2013 Federal Budget, the Government targeted a category of transactions, dubbed "character conversion transactions", which the Department of Finance ("**Finance**") contended inappropriately used "derivative forward agreements" ("**DFAs**") to convert investment returns that would otherwise be taxable as ordinary income into capital gains, only half of which would be subject to tax (the "Character Conversion Proposals") (for further information on the original Character Conversion Proposals, please see our earlier bulletin: "[Budget 2013: Deconstructing Derivatives – Capturing Character Conversion Transactions](#)").

Subsequent to the release of the Character Conversion Proposals, Finance indicated that the original proposals were intended to offer grandfathering relief from the application of the new rules in respect of certain DFAs ("**Existing DFAs**") entered into before March 21, 2013 (the "**Budget Date**"), provided (i) the terms of such Existing DFAs were not extended, and (ii) the notional amounts were not increased (i.e., "upsized"). In addition, Finance further indicated that the Character Conversion Proposals were intended to be interpreted as providing taxpayers with a 180 day grandfathering period in respect of the first DFA entered into after March 20, 2013 - in effect, deferring the full application of the Character Conversion Proposals for at least 180 days after the Budget Date. However, the

limited grandfathering relief offered under the original Character Conversion Proposals, and the uncertainty that arose in interpreting the scope of the proposals, raised concerns about whether investment funds that were parties to DFAs would have sufficient time to transition their Existing DFAs into new investment structures, and whether funds that had upsized their DFAs (or would upsize their DFAs in the normal course of their administration) would continue to be entitled to grandfathering relief.

proposed new grandfathering rules

In response to concerns raised by the investment fund community, Finance released a backgrounder on July 11, 2013 (the "**Backgrounder**"), which outlined changes to the Character Conversion Proposals that the Government intends to introduce that will extend the grandfathering relief to be offered in respect of certain DFAs until the end of 2014, and will permit some "upsizing" of DFAs, albeit in very restricted circumstances.

The most significant change announced by Finance in the Backgrounder is an extension of the grandfathering relief to be offered in respect of the duration of Existing DFAs. Specifically, the terms of Existing DFAs may now generally be extended until the end of 2014, and new DFAs that are entered into as part of a series of agreements that includes an Existing DFA may now generally be entitled to grandfathering relief, provided the series concludes and the last DFA in the series is settled prior to 2015. However, in both cases, grandfathering relief will only be available where the DFAs comply with certain "growth limits" (as discussed below). The effect of this change is to generally give taxpayers until at least the end of 2014 to unwind their existing DFAs (provided they comply with the newly announced "growth limits").

Existing DFAs that were originally scheduled to terminate after 2014 will continue to be entitled to grandfathering relief after 2014 (provided the terms of such agreements are not extended). However, such DFAs must comply with the newly announced "growth limits". Moreover, under the new proposals set out in the Backgrounder, grandfathering relief will now ultimately expire on March 21, 2018 (i.e., 5 years after the Budget Date), regardless of the termination date of the Existing DFA.

As noted above, grandfathering relief will only be available for Existing DFAs that adhere to special "growth limits", as more particularly set out in the Backgrounder. In order to adhere to the newly announced "growth limits", the "notional amount" of an Existing DFA (i.e., the value of the relevant reference asset under the DFA) after March 20, 2013 cannot exceed the total of:

- (a) its notional amount immediately before the Budget Date (the "**Original Notional Amount**");
- (b) any net increases in the notional amount of the DFA after March 20, 2013 that arise as a consequence of changes in the value of the underlying reference asset of the DFA (and not new investments in the DFA);
- (c) the amounts of any settlements of the DFA that occurred after March 20, 2013, that are immediately "reinvested" in the DFA or "invested" in a replacement DFA;
- (d) the amount of any cash held by the taxpayer immediate before the Budget Date that can reasonably be considered to have been committed to the DFA before the Budget Date;
- (e) any increase in the DFA after March 20, 2013 arising from the investment of the proceeds from the exercise of an over-allotment option in respect of an offering of securities where the option was granted before the Budget Date; and
- (f) increases in the notional amount not described above, up to a maximum of 5% of the Original Notional Amount, where the increases occurred after March 20, 2013 *and before July 11, 2013*.

Finally, the Backgrounder provided that the scope of the available grandfathering relief would be extended to accommodate the merging of investments that are each parties to Existing DFAs. In considering the combination of such funds special consideration will need to be devoted to the implication of the merger where the

scheduled termination dates of Existing DFAs of the predecessor funds are not substantially similar.¹

comments

Although some of the proposed changes set out in the Backgrounder, particularly the extension of the grandfathering period for many Existing DFAs, are welcome, the extended relief announced by Finance in the Backgrounder is nevertheless quite narrow.

The proposed "growth limits" were clearly intended to limit, with narrow exceptions, new investments in Existing DFAs. For example, the ability to increase the notional amount of an Existing DFA by up to 5% of the Original Notional Amount, as described in paragraph (f) (above), only applies to increases that occurred *before* July 11th, 2013. We understand that this provision was intended principally to provide relief for funds that upsized their DFAs shortly after the Budget Date and before Finance issued supplementary guidance as to the scope of the Character Conversion Proposals. Since many funds with Existing DFAs stopped accepting new investments following the Budget Date, this change likely provides only limited relief.

We also note that the description of the applicable "growth limits" in the Backgrounder may invite interpretations that differ from the scope of the limitations that may have been intended by Finance. For instance, the Backgrounder states that the "growth limits" will accommodate increases in the notional amount of a DFA by "the amounts of any settlements of the [DFA] after March 20, 2013 that are reinvested in the [DFA]... or are invested in a replacement [DFA]". While one could interpret this statement as permitting a fund that has previously partially pre-settled a DFA to facilitate a redemption of units to subsequently reinvest in the DFA, provided the notional amount of the DFA does not increase beyond the

¹ Finance is proposing to permit the upsizing of DFAs arising as a result of a merger of investment funds, provided that (i) the term of the "surviving" DFA does not exceed the term of either of the predecessor DFAs, and (ii) the notional amount of the "surviving" DFA does not exceed the combined notional amounts of the predecessor DFAs.

Original Notional Amount, we understand that the Backgrounder was not intended to be interpreted in this manner. Rather, we understand that the relevant legislation will ultimately provide that an increase in the notional amount of a DFA by an amount equal to an earlier settlement (or an investment in a replacement DFA) will only be permitted where the increase (or reinvestment) *immediately* follows the earlier settlement (as described in paragraph (c), above).

We understand that draft legislation reflecting the latest proposed amendments described in the backgrounder will likely not be released until the end of the summer. Accordingly, caution should be exercised in applying the relief announced in the Backgrounder to the circumstances of a particular investment fund.

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[a cautionary note](#)

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