

1.1.2 OSC Staff Notice 81-719 – Effect of Proposed Income Tax Act Amendments on Investment Funds – Character Conversion Transactions

OSC STAFF NOTICE 81-719

**EFFECT OF PROPOSED INCOME TAX ACT AMENDMENTS
ON INVESTMENT FUNDS – CHARACTER CONVERSION TRANSACTIONS**

Purpose

This notice sets out the views of staff of the Ontario Securities Commission (Staff) on the types of considerations investment fund managers should be contemplating in response to proposed amendments to the *Income Tax Act* (Canada) (the Tax Act) that impact investment funds that engage in character conversion transactions (as described below).

Background

On March 21, 2013, the Minister of Finance presented the federal government's 2013 budget. The budget contains proposed amendments to the Tax Act (the Budget Amendments), which impact certain investment funds that use specified derivatives (generally a forward agreement) to provide investors with an economic return based on the performance of a reference fund. The Budget Amendments will apply to forward agreements entered into on or after budget day as well as forward agreements entered into before budget day if the term of the agreement is extended on or after budget day.

Through the use of a forward agreement, an investment fund characterizes the economic return of a reference fund, which would otherwise be treated as ordinary income in the hands of its securityholders, as capital gains. Investment funds that employ this structure generally have investment objectives of providing "tax advantaged" returns to securityholders.

The Budget Amendments will effectively prohibit the character conversion described above, meaning that the economic returns provided to investors will be taxable as ordinary income.

Staff's Views

Staff are of the view that investment fund managers should consider the effects of the Budget Amendments on their investment funds that use these investment structures, particularly if the income conversion feature is an essential aspect of the fund, as evidenced by the fund's investment objective, its name or the manner in which the fund is marketed. As such, we ask investment fund managers to consider their disclosure obligations under the *Securities Act* (Ontario) and National Instrument 81-106 *Investment Fund Continuous Disclosure*.

While these considerations are underway, we ask managers to consider the need to cap their affected funds to new and additional investments. Investment fund managers may also wish to consider whether any communication with current securityholders of their funds is appropriate to notify them of the Budget Amendments and their potential impact on the applicable funds.

While investment fund managers and their counsel work to better understand the full impact of the Budget Amendments, Staff are of the view that managers must also consider their longer-term response to the Budget Amendments, including whether changes to their funds' investment objectives and investment strategies will be needed or whether the funds need to be restructured, reorganized or terminated.

Further Information

Filers and their counsel are encouraged to contact Staff to discuss the issues raised in this notice.

Questions

If you have any questions, please refer them to:

Mostafa Asadi
Legal Counsel, Investment Funds Branch
Ontario Securities Commission
Phone: 416-593-8171
E-mail: masadi@osc.gov.on.ca

Ian Kearsey
Legal Counsel, Investment Funds Branch
Ontario Securities Commission
Phone: 416-593-2169
E-mail: ikearsey@osc.gov.on.ca

Irene Lee
Legal Counsel, Investment Funds Branch
Ontario Securities Commission
Phone: 416-593-3668
E-mail: ilee@osc.gov.on.ca

Darren McKall
Manager, Investment Funds Branch
Ontario Securities Commission
Phone: 416-593-8118
E-mail: dmcall@osc.gov.on.ca

April 3, 2013