TAXADVISOR

Dealing with windfalls

Test case challenges the tax picture for those with funds affected by the late-trading scandal

COURT REPORT

BY JAMIE GOLOMBEK

Last month, the Ontario Securities Commission announced the five mutual fund companies implicated in late-trading and market-timing activities back in 2003 have been given an additional two years to distribute any remaining settlement monies to affected investors.

Coincidentally, the taxation of the settlement amounts received by mutual fund investors who held units in their registered plans has also resurfaced in a recent tax case decided this spring (*Lavoie v. The Queen, 2009 TCC 293*).

In his RRSP, Waterloo-based Russell Lavoie owned units of various mutual fund trusts, including Franklin Templeton Mutual Funds and AIC Mutual Funds, investigated in the United States in 2003 for abusive trading practices, specifically late trading and market timing.

Following U.S. investigations, the OSC, in cooperation with the Investment Dealers Association of Canada (now IIROC) and the Mutual Fund Dealers Association of Canada, began an inquiry into potential late-trading and market-timing activities in Canada.

It concluded these companies "failed to protect the best interests of their funds . . . [and] acted contrary to the public's interests by neglecting to implement appropriate measures to protect their mutual funds against the harm associated with frequent trading and market-timing activities."

The OSC reached settlements with five mutual fund companies, including AIC and Franklin Templeton, and had them compensate impacted unitholders.

AIC paid nearly $60 million; Franklin Templeton paid nearly $50 million. In total, the five Canadian mutual fund companies disbursed over $200 million.

According to the approved settlements, investors with affected mutual funds inside of registered plans, such as RRSPs or RRIFs, would receive payments directly as opposed to being paid to the plans themselves.

In September 2005, Lavoie received three cheques from AIC and Franklin Templeton totalling approximately $313.

While hardly worth going to tax court over, the judge acknowledged the "case is significant not only to Lavoie, but also to a large number of other taxpayers who received payments as a result of these agreements."

Lavoie cashed the cheques but didn't include the $313 in his 2005 tax return. He was reassessed by the CRA in 2007 and argued the payments were not income from a source and thus are a windfall and non-taxable.

The CRA objected to the windfall argument. It maintained since the amounts were paid in compensation for the harm caused to Lavoie's fund holdings in his RRSPs, they are akin to monies received "as benefits out of or under [an RRSP]" and are therefore taxable.

Lavoie's main argument was based on an old case (*The Queen v. Cranswick, 82 DTC 6073*) where a voluntary payment offered by the majority shareholder and parent company of a corporation to a minority shareholder was found to be a windfall.

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Unfortunately for Lavoie, for various reasons the judge felt the payment by the fund companies did not meet the Cranswick criteria and therefore was not a windfall and was fully taxable.

Interestingly, however, the judge did say Lavoie could have handed the payments he personally received over to his RRSP trustee to be added to the RRSP's assets, even though he didn't have any RRSP contribution room available. Presumably, this would have had the effect of deferring the tax on the payments until ultimate withdrawal.

Lavoie has appealed the decision to the Federal Court of Appeal. AER

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