Mutual Fund Corporations

Weighing the tax advantages over mutual fund trust

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When it comes to mutual fund investing, the discussion generally focuses on what stocks, bonds, or other investments are in a particular fund. There is, however, another area of fund investing that's worth considering: whether your client's investment is best placed in a mutual fund that is structured as a trust or one that is structured as a corporation.

Mutual fund trusts versus corporations
Originally, most funds were formed as mutual fund corporations (MFC), but as the mutual fund industry evolved, mutual fund trusts (MFT) became the preferred structure because they were better vehicles to flow through income than MFCs. Recently, the fund industry renewed its interest in MFCs because they can be structured with multiple classes of shares, each representing a different investment strategy. This has certain tax advantages for investors that cannot be achieved with MFTs.

Deferral of tax – switching
Generally, when an investor sells an investment in one fund to purchase units of a different fund, any capital gain is immediately taxable. However, because of a special rule in the Income Tax Act, investors who switch from one class to another within the same MFC do not trigger a disposition and, therefore, will not realize an immediate capital gain or loss. The adjusted cost base (ACB) of the investment in the MFC remains unchanged, and tax on any gain is deferred until the investor redeems out of the MFC structure. This is generally considered to be the primary benefit of investing in an MFC.

Distributions – trusts versus corporations
At year-end, mutual funds of all types generally distribute taxable income to avoid the high rate of taxation on that income if taxed inside the fund. MFTs permit all types of income (interest, Canadian dividends, foreign income) and capital gains earned by the trusts to flow through to investors and retain their tax characteristics in investors' hands. MFCs, on the other hand, only provide a limited flow-through in that only Canadian dividends and capital gains can be passed on directly to investors. Interest and foreign income earned inside an MFC are taxable first inside the MFC and can only be distributed after tax in the form of a taxable Canadian dividend to its investors. This makes MFCs unsuitable for non-equity type funds since any interest income could potentially be taxed twice.

Distribution minimization in MFCs
In the corporate structure, only one corporate tax return is filed for the entire MFC, notwithstanding the fact that there may be multiple classes of shares representing multiple investment strategies within the corporation. As a result, distributions can often be lower under an MFC than they would be in an MFT because of the ability to share losses among the different classes of an MFC.

For example, assume there are only two classes in an MFC: Class A has $1,000 of gains and Class B has $1,000 of losses. Class B can loan its losses to Class A to offset Class A's capital gains and eliminate its distribution. If the two funds were structured as MFTs, there would be a distribution of $1,000 from

Fund A and no distribution by Fund B. This is why the MFC structure may minimize the amount of taxable distributions for investors.

Foreign content planning

Although MFCs are mainly of interest to investors with taxable non-registered accounts, investors who hold MFCs inside registered plans, such as RRSPs or RRIFs, may also benefit. This is because switches between classes of shares of the same MFC do not change the cost amount (or book value) for the purposes of calculating the foreign content limitation of 30 per cent. If the investor owns a class of shares of an MFC that has increased in value and represents foreign content in his or her registered plan, he or she need not worry about being offside the foreign content limit as a result of switching to another class within the MFC as the book value is not reset to fair market value upon the switch.

Capital tax planning

Corporations may be liable to pay capital tax to the federal government as well as to some provinces if the corporation has a permanent establishment in these provinces. Capital tax is calculated on a certain percentage of the capital tax base, which is generally the taxable paid-up capital. In computing taxable paid-up capital, corporations may claim an investment allowance as a deduction from paid-up capital. This deduction is granted to minimize double-taxation that can result from including the qualified investments in the paid-up capital of the lending corporation as well as the borrowing corporation.

Investments in shares of MFCs are generally considered to be eligible for the investment allowance for federal and provincial capital taxes. However, MFT investments are generally not eligible. Therefore, a corporate investor may pay less federal and provincial capital tax if it invests its money in MFCs instead of MFTs.

Tax reporting

Tax slips are sent to all investors at year-end. Shareholders of MFCs receive a T5 Supplementary, which records both taxable Canadian dividends and capital gains dividends received by each investor. Unitholders of MFTs receive a T3 Supplementary, which records the amount of distributions including interest, foreign income, capital gains, and Canadian dividends received by each investor.

Call to action

The next time you sit down with your clients to recommend a fund, don't forget to share with them the potential advantages of investing in an MFC as opposed to an MFT.