

Understanding Taxation of Funds

Segregated and Mutual Funds

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A description of the key features of the individual variable insurance contract is contained in the Information Folder for the product being considered. **Any amount that is allocated to a Segregated Fund is invested at the risk of the contract owner and may increase or decrease in value.**

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Agenda

Taxation of Funds

- How they work
 - Segregated v. Mutual
 - Payout Plans
 - Treatment of Capital
- 
- Excluding company and shareholder taxation of passive income



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When is tax triggered?

- Client makes a switch in investment holdings
- Fund manager makes a switch in investment holdings
- Client makes a withdrawal and fund manager needs to sell off investment holdings
- Accumulating growth (in terms of capital gains) doesn't trigger tax unless it is realized
 - The holding is sold
 - Triggers capital gain or capital loss



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Taxes not necessarily related to growth

1. Tax slip issued for interest, dividends and capital gains and fund value went down
 2. Tax slip issued for small or negligible amounts when fund value went up
- Tax slip issued when income is realized on sale or withdrawal



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Differences between non-registered funds

	Segregated Funds	Mutual Funds
T-3 reporting	• Allocated income plus realized capital gains or losses on units surrendered	• Distributions + return of capital
Income allocation	• Reflected in value of fund • Not deposited into policy (no \$\$ or units) • Capital gains and losses	• Paid in cash or cash into account to purchase new units • Capital gains, not losses • Return of capital does not purchase new units
Calculations	• Insurance Company handles calculations	• Account-holder must calculate and report capital gain (loss) on unit redemption

Segregated fund itself never has taxable income under Para. 138.1(1)(f) and ss. 138.1(3)



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Fund Level Activity	Type of Income Earned	T3 Canadian residents	Tax Treatment non registered funds
Canadian Treasury bills, bonds, mortgages, index futures	interest	Box 26	Fully taxable at marginal tax rate
Canadian corp. shares	dividends	Box 49 or 23	Dividend tax credit Eligible Box 51 Ineligible Box 39
Foreign bonds and corp. shares	foreign	Box 25	Fully taxable. Foreign taxes deducted before allocations to client
Sale of investments owned by segregated fund (manager)	Capital gain or loss	Box 21 capital gains Box 37 capital losses	50% of gains and losses allocated to unitholders taxed at marginal tax rate
Surrender/redemption of units by client (valued at time of redemption/surrender)		Box 21 capital gains Box 37 capital losses	Capital gain if market value > ACB Capital loss if market value < ACB Guaranteed top up treated as capital gain

Simpler Reporting: Segregated Funds

- Insurance company tracks adjusted cost base for income tax
- Company calculates capital gain/loss on redemption
- Reported on T3
 - Client includes amounts in Box 21 or Box 37 on income tax return
- Guaranteed top up reported as capital gain
 - Offsets reported capital loss; so net zero impact
- T3 does not include unrealized income



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Transparent Reporting: Segregated Funds

- Segregated funds allocate capital losses
 - Offset against gains from any source
 - Offset in current year, previous 3 years or carry forward indefinitely
- Taxable income not related to changes in market value
- T3 reports client share of allocated income of fund plus any realized capital gain or loss from redemption/surrender of units
- Change in fund value over the year represents unrealized capital gain/loss because market value has gone up/down



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Income and Distribution Reporting

Guaranteed Withdrawal Benefit Segregated or Mutual Fund

Example

\$ 100,000	investment
\$ 1,000	interest earned
\$ 2,000	eligible dividends
<u>\$ 2,500</u>	realized capital gains
\$ 5,500	taxable reporting

And Cash Flow

4% payout	\$4,000
5% payout	\$5,000



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Income and Systematic Withdrawal Reporting Segregated Fund

Canada Revenue Agency / Agence du revenu du Canada Year / Année **2020** STATEMENT OF TRUST INCOME ALLOCATIONS AND DESIGNATIONS / ETAT DES REVENUS DE FIDUCIE (RÉPARTITIONS ET ATTRIBUTIONS) **T3**

Actual amount of eligible dividends / Montant réel des dividendes éligibles déterminés 40 2,000.00	Taxable amount of eligible dividends / Montant imposable des dividendes éligibles déterminés 50 2,760.00	Dividend tax credit / Crédits d'impôt pour dividendes déterminés 51 4,140.00	Capital gains / Gains en capital 21 2,500.00	Capital gains eligible for deduction / Gains en capital admissibles pour déduction 52
Actual amount of dividends other than eligible dividends / Montant réel des dividendes autres que des dividendes éligibles déterminés 24	Taxable amount of dividends other than eligible dividends / Montant imposable des dividendes autres que des dividendes éligibles déterminés 54	Dividend tax credit for dividends other than eligible dividends / Crédits d'impôt pour dividendes autres que des dividendes éligibles déterminés 55	Other income / Autres revenus 26 1,000.00	Trust year end / Fin d'année de la fiducie 56

Box 26 – Interest

Recipient's name (last name first) and address – Nom, prénom et adresse du bénéficiaire

Trust's name and address – Nom et adresse de la fiducie

Recipient identification number / Numéro d'identification du bénéficiaire **12 T3 (11)**

Account number / Numéro de compte **14 T**

Report code / Code du genre de feuillet **16**

Beneficiary code / Code du bénéficiaire **18**

For information, see the back. / Pour obtenir des renseignements, lisez le verso.

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Income and Distribution Reporting Guaranteed Withdrawal Benefit Segregated Fund

Example

\$ 100,000	investment
\$ 1,000	interest earned
\$ 2,000	eligible dividends
<u>\$ (2,500)</u>	realized capital gains
\$ 3,000	taxable reporting

And Cash Flow

4% payout	\$4,000
5% payout	\$5,000

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Income and Distribution Reporting Segregated Fund

Canada Revenue Agency / Agence du revenu du Canada		Year / Année	2020		STATEMENT OF TRUST INCOME ALLOCATIONS AND DESIGNATIONS / ÉTAT DES REVENUS DE FIDUCIE (RÉPARTITIONS ET ATTRIBUTIONS) T3	
Actual amount of eligible dividends / Montant réel des dividendes éligibles déterminés	Taxable amount of eligible dividends / Montant imposable des dividendes éligibles déterminés	Dividend tax credit / Crédit d'impôt pour dividendes déterminés	Capital gains / Gains en capital	Capital gains eligible for deduction / Gains en capital admissibles pour déduction		
40 2,000.00	50 2,760.00	51 4,140.00	21	30		
Actual amount of dividends other than eligible dividends / Montant réel des dividendes autres que des dividendes éligibles déterminés	Taxable amount of dividends other than eligible dividends / Montant imposable des dividendes autres que des dividendes éligibles déterminés	Dividend tax credit for dividends other than eligible dividends / Crédit d'impôt pour dividendes autres que des dividendes éligibles déterminés	Other income / Autres revenus	Trust year end / Fin d'année de la fiducie	Year / Année	
24	27	28	26 1,000.00	Year / Année	Month / Mois	
Other information (see the back) / Autres renseignements (lisez le verso)	Box / Case	Amount / Montant	Box / Case	Amount / Montant	Notes / Remarques	
	37	2,500.00			Box 26 – Interest Box 37 – Capital Loss	
Recipient's name (last name first) and address – Nom, prénom et adresse du bénéficiaire			Trust's name and address – Nom et adresse de la fiducie			
Recipient identification number / Numéro d'identification du bénéficiaire T3 (11) 12			Account number / Numéro de compte 14 T		Report code / Code du genre de feuillet 16	
Beneficiary code / Code du bénéficiaire 18			For information, see the back. / Pour obtenir des renseignements, lisez le verso.			

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Case Study Examples Segregated Funds

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Case Study 1

- Simple taxation of Guaranteed Withdrawal Benefit
- Client makes no switches
- Class 3.0 cash flow achieved by redeeming/selling units
- Operates like a systematic withdrawal plan
- Triggers capital gain/loss
- Assume no fund income allocations in the year



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Taxation of Guaranteed Withdrawal Benefit

(Class Plus 3.0) Income

Original Investment base	Adjusted cost	\$300,000
Growth		5%
Market Value (unrealized capital gain)*		\$315,000
Guaranteed Withdrawal Amount		\$12,000
Realized capital gain $\$((315,000 - 15,000) / 315,000) \times 12,000$		\$571 (reported)
Taxable capital gain (50%)		\$ 286
Tax Payable (assume 30%)		\$ 86
Net cash flow $\$(12,000 - 86)$		\$11,914

*Assume all equity growth; no unitholder trades or switches



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Case Study 2

- Taxation of Guaranteed Withdrawal Benefit when fund income allocations made
- Fund allocates earned income (interest, dividends, capital gains/losses) proportionately by fund class
 - All unitholders throughout the year
 - Reported to unitholder annually
- Class Plus cash flow achieved by redeeming/selling units
- Operates like systematic withdrawal plan



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Triggering Capital Gain/Loss

1. **If client makes switch or withdrawal during year or**
 2. **If client makes no switches and fund manager sells an underlying security,**
- T3 slip reflects realized capital gain/loss from disposition/deemed disposition



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Taxation of Guaranteed Withdrawal Benefit

(Class Plus 3.0) Income

Original Investment Adjusted cost base	\$300,000
Growth	5%
Market Value	\$315,000
Annual Fund Income Allocation:	\$ 3,500
Eligible Dividends: \$2,000	
Capital Gains: \$1,500	
Revised adjusted cost base	\$303,500
Guaranteed Withdrawal Amount	\$ 12,000

*Assume no unitholder trades or switches



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Taxation of Guaranteed Withdrawal Benefit

(Class Plus 3.0) Income

Original Investment Adjusted cost base	\$300,000
Growth (@ 5%)	\$15,000
Market Value	\$315,000
Capital gain on redemption of units $\$((315,000 - 303,500)/315,000)12,000$	\$ 438
Taxable capital gain 50% $\$(1,500 + 438)$	\$ 969
Tax on capital gains 30% x \$969	\$ 291
Tax on dividends after dividend tax credit 9% x \$2,000	\$ 180
Net cash flow $\$(12,000 - (291 + 180))$	\$ 11,529



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Case Study 3

- Taxation of Guaranteed Withdrawal Benefit when fund income allocations made
- Investment income for the year is \$2,000 Canadian eligible dividends and \$1,500 allocated segregated fund losses
- Fund allocates segregated fund losses
 - All unitholders throughout the year
 - Reported to unitholder annually
- Class Plus cash flow achieved by redeeming/selling units
- Operates like systematic withdrawal plan



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Taxation of Guaranteed Withdrawal Benefit (Class Plus 3.0) Income

Original Investment Adjusted cost base	\$300,000
Growth (@ 5%)	\$15,000
Market Value	\$315,000
Annual fund income allocation Canadian eligible dividends \$2,000 Allocated segregated fund losses (\$1,500)	\$500
Withdrawal	\$ 12,000



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Taxation of Guaranteed Withdrawal Benefit

(Class Plus 3.0) Income

Original Investment Adjusted cost base	\$300,000
Growth (@ 5%)	\$15,000
Market Value	\$315,000
Capital gain on redemption of units $\$((315,000 - 300,5000)/315,000)12,000$	\$ 552
Net capital loss 50% $\$(-1,500 + 552)$	-\$ 474
Tax on dividends after dividend tax credit 9% x \$2,000	\$ 180

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Client's T-3 Information Slip

Income Type	Box
Eligible Dividends	49
Taxable amount of eligible dividends	50
Dividend tax credit for eligible dividends	51
Capital Gains	21
Insurance segregated fund net capital losses	37

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Guaranteed Income Phase

- Market value of fund class units = 0
- “Income base” for lifetime withdrawal amount is positive
- Taxation uncertain from ITA (Canada) perspective
- General approach (including Empire Life) currently
 - Reports payments based on understanding of legislation and CRA assessing practices at time of payment
 - Currently would report as capital gain (para. 138.1(1)(j))
 - ***policyholder responsible for any tax liabilities arising from any change in law, interpretation, or CRA assessing practice***



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Deferring tax on death (non-registered funds)

- Deceased taxpayer deemed to have sold all capital property owned by him/her, immediately before death
- No withholding tax on payout to beneficiaries
- May effect tax free rollover to deceased's spouse/common law partner (ss 70(6) ITA)
- Appoint successor annuitant and name spouse as successor holder
- Taxes triggered on death of last annuitant



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Understanding your Empire Life T3/Relevé 16

Understanding your Empire

You have received a T3 slip because you have earned income from within a non-registered segregated fund policy. If you are an investor in the fund, the income that is allocated from the fund is not actually yours until it is distributed to you. The income that is allocated from the fund is not actually yours until it is distributed to you.

You have also received a Reinvest 16 slip. The income that is allocated from the fund is not actually yours until it is distributed to you. The income that is allocated from the fund is not actually yours until it is distributed to you.

Segregated funds allocate income on an annual basis to each of the investors in the fund. The income that is allocated from the fund is not actually yours until it is distributed to you. The income that is allocated from the fund is not actually yours until it is distributed to you.

paid to you but profits is reinvested into the fund and is reflected by an increase in the unit price.

not report taxable income as follows:

Investor	T3	Reinvest 16	Tax treatment
Investor 1			Investment is fully taxable and will be taxed at your marginal rate.

Fund-level activity		Client-specific activity	Type of income earned	T3	Box 16	Box 16	Tax treatment
Canadian, Treasury bills, Municipal Bonds		Interest	Interest	Box 26	Box 16	Box 16	Interest is taxable and will be taxed at your marginal tax rate
Canadian, Treasury bills, Municipal Bonds, Real Estate, Commodity		Dividends	Dividends	Box 49 or Box 25	Box 17 or C2	Box 17 or C2	Dividend income receives a dividend tax credit. There are different dividend tax credit rates for eligible and ineligible dividends that are reported in Box 17 and Box 39 non-eligible dividends that are reported in Box 39. Non-eligible dividends that are reported in Box 39 are taxed at the 28% dividend tax credit is reported in Box 25
Shares of Canadian corporations		Foreign	Foreign		Box F	Box F	Interest and dividends received from foreign bonds and corporations are fully taxable in Canada. Often the tax jurisdictions also taxes the income in their tax base. If the corporation also taxes the income in their tax base, the tax jurisdiction also taxes the income from all allocations
Foreign bonds and shares of foreign corporations		Capital gain or loss	Capital gain or loss	Box 21, capital gains	Box A	Box A	Capital gains qualify for preferential tax treatment and are taxed at 50% of your marginal tax rate. The total of all capital gains or losses is reported in Box 21. Capital gains earned within are designated foreign, the net amount is then allocated to you
Sale of shares or units at a profit or loss by the beneficiary fund		Capital gain or loss	Capital gain or loss	Box 22, capital gains	Box A	Box A	Clients who surrender units of a segregated fund during the year will realize a capital gain if the market value when they sell is greater than the allocated cost basis (ACB) of the surrender. If the market value at date of surrender is less than the ACB, the resulting loss is reported in Box 22. The payment of a guaranteed payout on maturity of the policy or on the basis of the actuarial of the policy will be reported as a capital gain
Surrender of units in the segregated fund by the client		Capital gain or loss	Capital gain or loss				Capital gains (losses) from the segregated fund and the realized capital gains (losses) from the segregated fund are reported in Box 23 (31) relative to both the allocated capital gains (losses) from the segregated fund and the realized capital gains (losses) from the segregated fund. Information about how to report the income from your T3 (Revised) 2014 is available at www.cra.ca/131360131

The amount of your capital gains (losses) reported in Box 23 (37) reflects **both** the allocated capital gains (losses) from the segregated fund and the realized capital gain (loss) from the units during the year. The reverse side of your slip contains important information about how to report the income from your T3 (Revised 06/16/2016).

For more information, visit www.cra-arc.gc.ca and www.revenu.gov.gc.ca

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[illegible]

Original Investment (ICs)	Creation eligible dividends (\$'000)	\$480,000
Annual dividend received	Creation eligible dividends (\$'000)	
As investment	Creation eligible dividends (\$'000)	
Unlevered ICs	Creation eligible dividends (\$'000)	
Growth rate	Creation eligible dividends (\$'000)	
Market Value	Creation eligible dividends (\$'000)	
With interest	Creation eligible dividends (\$'000)	
Capital gains on redemption of units	Creation eligible dividends (\$'000)	
After-tax ICs	Creation eligible dividends (\$'000)	
Tax payable on dividends	Creation eligible dividends (\$'000)	

---registered contract examples outlined above are for illustrative purposes only and should not be construed to be tax advice as each client's situation is different. In years with market downturns, withdrawals from Class Plus 1.0 will

Example 1 – Single Taxation of Class Pass 3.0 Income

[illegible]

Example 2 - Taxation of Class Plus 3.0 income with alternative minimum tax

The Fund Class units is 50 and the Income Base for the benefits associated with a guaranteed minimum. It reports any payments during the Guaranteed and CRA assessing practices at the time of payment. on any change in law, interpretation, or CRA



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Review

Taxation of Funds

- ✓ How they work
- ✓ Segregated funds vs. Mutual funds
- ✓ Payout Plans
- ✓ Treatment of Capital payments



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