



CICA Handbook Section 3465, *Income Taxes*

Application to Mutual Fund Corporations

An update for the Investment Management Industry

In a previous newsletter, we summarized the status of a variety of important issues related to the application of CICA Handbook Section 1100 *Generally Accepted Accounting Principles* to investment funds. In that newsletter, we stated that we did not expect the Emerging Issues Committee (EIC) to extend to mutual fund corporations the exemption that mutual fund trusts have with respect to applying the principles of Section 3465 *Income Taxes*. We continue to believe that the EIC will not extend this exemption to mutual fund corporations. Accordingly, we set forth below practical guidance related to the application of Section 3465 to mutual fund corporations. As current income taxes have generally already been accounted for by mutual fund corporations in accordance with the recommendations of Section 3465, this guidance is focused on future income taxes. Those responsible for the preparation of the financial statements and the net asset values of a mutual fund corporation should consider its particular circumstances when applying Section 3465.

In this newsletter, we use the term fund to mean a mutual fund corporation as defined in the Income Tax Act (Canada) (the Act). Furthermore, this guidance is directed towards funds that have a policy of making all income and capital gains distributions to shareholders as permitted under the Act.

Topic	Description	Impact on Fund
General Principle	Temporary differences between the accounting and income tax values of assets and liabilities of a mutual fund corporation give rise to future income tax assets and liabilities.	Future income tax liabilities should be recognized by mutual fund corporations. Future income tax assets should also be recognized, but only to the extent that such assets are more likely than not to be realized.

Topic	Description	Impact on Fund
Unrealized gains on investments	<p>Net capital gains realized by a mutual fund corporation result in income taxes payable that are generally refundable through mechanisms available in the Act, most notably through the payment of sufficient capital gains dividends.</p>	<p>A future income tax liability exists equal to the fair value of the portfolio less its adjusted cost base, multiplied by the effective income tax rate. A future refundable income tax asset shall exist, which offsets this liability, when the fund intends to pay sufficient capital gains dividends to trigger the refund of income taxes paid.</p> <p>Ordinarily, no net future income tax liability is expected.</p>
Unrealized losses on investments and unused capital losses.	<p>Capital losses carried forward from prior years will reduce any future capital gains taxes that would otherwise be payable, representing a potential asset to the fund.</p> <p>Unrealized capital losses are similar, in that any future realization will reduce capital gains taxes that would otherwise be payable.</p>	<p>Capital losses serve to reduce refundable income taxes that might otherwise be payable in the future. As described above, a fund ordinarily will not bear net income taxes on capital gains due to the refunding provisions in the Act. Therefore, a full valuation allowance should ordinarily be applied to offset the future income tax assets triggered by these unrealized and unused capital losses.</p>
Unused non-capital losses	<p>Mutual fund corporations are subject to Part I income tax on their ordinary income. Unused non-capital losses, which may be carried forward ten years, can serve to reduce any future Part I taxes and therefore represent a potential asset to the fund.</p>	<p>A future income tax asset should be recognized to the extent that it is more likely than not that these unused losses will be utilized in the future.</p> <p>The investment strategy and earnings profile of the fund will significantly influence this assessment.</p>
Other Temporary Differences	<p>Temporary differences related to the timing of inclusion of dividend income and realized gains and losses (settled basis for income tax purposes) and to the deduction of financing charges (e.g. five year amortization for income tax purposes) should be considered in analyzing future income tax assets and liabilities.</p>	<p>To the extent that such temporary differences relate to items triggering refundable taxes, a net future income tax asset or liability would not ordinarily be expected. For example, dividends from taxable Canadian corporations generally result in the payment of refundable Part IV income taxes.</p> <p>To the extent that such differences relate to items taxable under Part I of the Act, a future income tax liability should be considered where the accounting bases exceed the income tax bases. Where the income tax bases exceed the accounting bases, a future income tax asset net of an appropriate valuation allowance should be considered.</p>

Topic	Description	Impact on Fund
Disclosure	Paragraphs 3465.91 to .101 of the CICA Handbook set out the disclosure recommendations in respect of income taxes.	<p>In addition to information regarding current income taxes typically already included in a fund's financial statements, disclosure of the following is recommended:</p> <ul style="list-style-type: none"> • Future income tax expense or benefit included in determination of net income. • The amount and expiry of unused income tax losses, as well as other deductible temporary differences, for which no benefit has been recognized. • The nature and tax effect of the temporary differences, unused tax losses and income tax reductions that give rise to future income tax assets and liabilities. Significant offsetting items included in future income tax assets and liabilities balances should be disclosed.

Summary

A fund that has policies in place to pass through all income and capital gains to shareholders and to trigger available refunds of taxes paid should not ordinarily recognize a net future income tax asset or liability in respect of capital items. Temporary differences relating to non-capital items may result in net future income tax liabilities or assets when the facts and circumstances of the fund indicate that a net charge or benefit will occur in the future.