Rules on mark-to-market properties — A pitfall to avoid

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The *Income Tax Act* (Canada) contains specific rules which apply to certain properties held by financial institutions known as the *mark-to-market properties* rules (hereinafter "MTMP"). These complex rules are often poorly understood and can result in unexpected tax consequences in various situations and, in particular, in the context of project financing involving the issuance of units in a limited partnership.

Generally when the MTMP rules apply, a financial institution must declare as income any increase in value not realized at the end of the taxation year on the MTMP held by such financial institution, whether or not such property was the subject of an actual disposition.

The expression "financial institution" is specifically defined for purposes of the MTMP rules and includes not only banks but insurance companies and entities controlled by insurance companies, as well as partnerships in which more than 50% of the fair market value of its interests are held by one or more financial institutions. In such a case, the partnership would automatically become subject to the MTMP rules to the extent that it holds MTMP. Such a partnership must therefore declare an income for the taxation year in question in respect of any increase in the value of the MTMP held by it, and allocate such income to all its unitholders, regardless of whether or not they are financial institutions.

Corporate shares will be considered to be MTMP where a financial institution holds less than 10% of the fair market value of the corporation's shares or of the voting rights attached to such shares. In addition, the definition of MTMP includes various other types of property the fair market value of which is attributable to MTMP. For example, mutual fund units, units in a limited partnership, insurance policies or other derivative financial instruments may be regarded as MTMP to the extent

that the value of such investments is primarily attributable (more than 50%) to MTMP.

However, it should be noted that the ownership of shares of an “eligible small business corporation” (defined for purposes of the MTMP rules as being a corporation whose assets have a carrying value which does not exceed $50,000,000 and which employs 500 persons or less) will not be considered to be MTMP.

The MTMP rules apply to financial institutions such as banks and insurance companies or any entity controlled by such financial institutions. However, as noted above, because of the broad definition of “financial institution” in the context of the application of the MTMP rules, other entities may also inadvertently be considered to be financial institutions if the percentage of their unit or share ownership is held by one or more financial institutions. In this regard and specifically in the context of the formation of a limited partnership which may eventually make investments which could be considered MTMP, it is important to provide for a clause limiting the ownership of units by financial institutions so as to ensure that the limited partnership will not be considered to be a financial institution under the MTMP rules. In the event that such a restriction is not desirable, the limited partnership agreement and the limited parntership’s investment policies should provide that the investments to be made by the limited partnership must not consist of MTMP. Thus, even if the limited partnership itself were considered to be a financial institution, the MTMP rules would have no impact since no investment made by the limited partnership would meet the definition of MTMP.

In conclusion, the MTMP rules must be taken into consideration in any major structured investment project, particularly in connection with a limited partnership in which financial institutions are likely to acquire a substantial interest.