THE INVESTMENT FUNDS INSTITUTE OF CANADA | L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA

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Ms. Alexandra MacLean
Director, Tax Legislation
Tax Policy Division
Finance Canada
90 Elgin Street
Ottawa, ON
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Dear Ms. MacLean:

RE: Qualified Investments, Registered Investments and Amendments to Part X.2 Tax

We are writing on behalf of the members of the Investment Funds Institute of Canada (IFIC) to request amendments to the *Income Tax Act* (Canada) (the "Act") to alleviate the inequitable application of Part X.2 tax on investment funds.

IFIC understands that some of our members have already had discussions with the department on this matter and this submission is intended to support those discussions. The current regime is unfair to non-registered investors due in part to conflicting business and regulatory obligations. To resolve these issues, IFIC proposes in this submission, three potential legislative amendments.

Overview of the Qualified Investment ("QI") and Registered Investment ("RI") Regimes

Part X.2 tax is part of a QI regime in the Act. The regime is designed to regulate investments held by Registered Retirement Savings Plans ("RRSPs"), Registered Retirement Income Funds ("RRIFs"), Tax-Free Savings Accounts ("TFSAs"), Registered Education Savings Plans ("RESPs"), Registered Disability Savings Plans ("RDSPs") and Deferred Profit Sharing Plans ("DPSPs") (each a "Registered Plan") and by certain entities that are RIs.

The annuitant or holder of a Registered Plan, or the Registered Plan itself, can be subject to highly punitive taxes if the Registered Plan invests in property that is not a QI ("NQI"). A significant portion of investors who purchase mutual funds do so through their Registered Plans. Therefore, the status of a mutual fund as a QI is usually a critical structuring issue. However, importantly, a mutual fund's status as a QI is not relevant to a taxable investor, pension plan or any other type of tax-exempt investor that is not a Registered Plan ("non-Registered Plan investor").

How Mutual Funds Become QI for Registered Plan Investors

Unlisted units of an investment fund that is established as a trust can be a QI in one of two ways. The fund can:

(i) Qualify as a Mutual Fund Trust ("MFT") under section 132(6) of the Act; or

(ii) Apply to the CRA to become a RI under section 204.4 of the Act.

Fund managers generally strive to have their funds qualify as MFT's for tax purposes. This requires a fund to satisfy a minimum investor threshold of 150 unitholders (each of whom holds a "block of units" worth at least $500) by the time the fund files its first tax return (i.e., generally by March 15th or 31st of the year after creation) so that it can elect to be deemed a MFT from the date of creation. Given that there is often some degree of commercial uncertainty at the time of launch as to whether or not a fund will qualify as an MFT from the date of creation, a fund will often apply to the CRA to become a RI so that the units of the fund can be sold to Registered Plan investors without the risk that they might be NQI. The ability to offer units of the fund to Registered Plan investors significantly increases the likelihood that the fund will obtain MFT status due to the fact that a substantial portion of investments in funds are made through Registered Plans. Approximately 55% of the AUM of the funds managed by IFIC Members is held in Registered Plans.

Impact to a Mutual Fund of being an RI and not a MFT

A fund that is a RI but not a MFT under the Act must limit its investments to QIs[1] in order to avoid the imposition of Part X.2 tax. Part X.2 tax is imposed at the rate of 1% of the cost[2] of any NQI held at the end of each month (i.e. 12% per year). Generally, a fund that revokes its RI status is deemed to continue to be a QI for Registered Plans (and other RIs) throughout the calendar year of revocation and the following calendar year.[3] The fund will also continue to be subject to Part X.2 tax on any NQI held by it at the end of any month during that period (unless the fund is a MFT at the relevant time).

The list of QIs includes, among other things:

(i) Securities (other than certain derivatives) listed on a stock exchange designated by Finance Canada ("designated stock exchange"). Most major stock exchanges (e.g., TSX, NYSE & LSE) are designated stock exchanges. Most stock exchanges in emerging market countries are not designated stock exchanges.

(ii) Debt issued by a corporation the shares of which are listed on a designated stock exchange.

(iii) Debt that had, at the time of acquisition, an investment grade rating by a credit rating agency prescribed under regulations to the Act and was part of a $25,000,000 issuance program.

(iv) Shares or units of a RI.

(v) Units of a MFT.

A fund that is a RI must file a T3RI Return and pay any Part X.2 tax liability within 90 days from the end of each taxation year. The CRA does not have discretion to waive Part X.2 tax – even in situations that do not offend the underlying policy objectives of the QI regime.

QI and RI Regime Challenges Faced by Mutual Funds

The QI and RI regimes are complex and have evolved over time in a manner that is not entirely intuitive. This is especially so in how the rules apply to investment funds, which may be subject to other competing, and in some cases conflicting, tax and regulatory regimes, as well as competing investment objectives. For any number of commercial reasons, the portfolio manager responsible for designing the investment strategy of a mutual fund may prefer, if tax were not an issue, to make NQIs such as unlisted shares, shares listed on exchanges that are not designated stock exchanges, forward contacts or futures contracts part of the fund's

[1] The restriction is to "prescribed investments", but these correspond with the list of QIs for Registered Plans.
[2] The tax actually applies on the fair market value of any NQI at the time of acquisition by the fund, which typically would be the cost of the NQI.
[3] Subsection 204.4(4) of the Act and paragraph 4900(1)(a) of the *Income Tax Regulations* (Canada).

investment portfolio and strategies. Mutual funds often encounter a "Catch 22" type of structuring issue at the time they are launched:

1) the fund intends to obtain MFT status so that its units will be QI (among other benefits of being a MFT) because it does not or cannot restrict its investment property to QI and would be subject to penalty tax if it registered as an RI,
   BUT
2) its ability to meet the MFT unitholder requirements is dependent on its eligibility to be held by Registered Plans, which imposes the need for units of the fund to be QI.

To deal with this dilemma, mutual funds may apply for RI status at the time of launch to allow for and protect Registered Plan Investors, with the aim of obtaining MFT status from inception, so that the fund's portfolio holdings need not be restricted to QI and monitored for compliance under Part X.2. However, circumstances (often beyond the fund's control) can arise that cause a fund to fail to obtain MFT status. For example, a fund that previously met the 150 unitholder requirement may drop below that requirement due to redemption activities. Due to the current operation of Part X.2, the tax imposed in these situations can be severe and inequitable for non-Registered Plan investors in the RI fund who would not otherwise be subject to Part X.2 tax. As an example, the cost of NQI holdings of the RI fund, and by extension its Part X.2 tax liability, can be significantly increased by large non-Registered Plan investors, such as large top fund mutual fund trusts or mutual fund corporations in fund-on-fund structures or large pension plan clients. None of these non-Registered Plan investors, or other non-Registered Plan investors in the fund, would be subject to penalty on a direct investment in the underlying NQI, but will be penalized where Part X.2 tax is levied on the RI.

Other less common situations, including administrative errors, can cause funds to accidentally run afoul of the QI regime rules. As an example, a fund that applies to be an RI, but that is ultimately never sold to Registered Plans or other RIs, or where there were no Registered Plan Investors or other RI investors remaining in the fund, has no mechanism to alleviate the inequitable Part X.2 tax that would apply if it were to hold NQI property, even though such a scenario is not intended to be captured within the scope of the QI regime. As in all cases where an RI has non-Registered Plan investors, the Part X.2 tax imposed under the current rules in this type of innocuous situation is overly punitive for the QI regime infraction committed.

Legislative Amendment Options for Consideration

We request that the following recommendations be implemented in order to alleviate inequitable Part X.2 tax penalties and make the QI and RI regimes fairer for investors in investment funds:

1. *Retroactively Change the Formula for Calculating Part X.2 Tax:* Amend subsection 204.6 of the Act so that Part X.2 tax is imposed on a RI only to the extent that units of the RI are held by investors subject to the QI regime (Registered Plans and RIs that are subject to Part X.2 tax). For greater certainty, if there were no investors in the RI who are Registered Plans or other RIs, the Part X.2 tax should not apply. This would be similar to the way in which the now repealed foreign property tax was applied to RIs under former subsection 206(2.01) of Part XI.
2. *Retroactively Create a New Category of Registered Investment:* Add a new category of RI that would apply to a trust that has at least 150 indirect investors. This "look-through" category would apply to a trust that would be a mutual fund trust if paragraph 132(6)(c) of the Act did not apply, but where the trust would otherwise be considered to be widely held on an indirect basis by looking through certain permitted unitholders (i.e. mutual fund trusts, mutual fund corporations, segregated funds, pension plans, etc.). This new category of RI would not be required to restrict its investments to QI.
3. *Permit the Application for Registration as an RI to be made for the previous year:* Amend subsection 204.4(1) so that a trust can apply to be registered as an RI as of a particular date in the year of application or as of a particular date in the year preceding the application. Often a fund would only realize that it was not going to achieve MFT status for its first taxation year after the end of that first taxation year, as it has until

March of the following year to satisfy the 150 unitholder threshold. This amendment would allow the fund to register back to that previous year.

Expanding the list of Designated Stock Exchanges

A significant portion of the investments made by the funds managed by IFIC members are securities listed on stock exchanges. The list of designated stock exchanges should be expanded to include major exchanges such as those listed in Appendix A. An expanded list will afford funds a greater universe of QI and will reduce uncertainty with regard to exchanges that have evolved from mergers and other changes. We are aware that the Department of Finance has received submissions on that issue and wish to highlight that this remains an issue of importance to our members.

Limitations of a Section 259 Election

While Section 259 of the Act provides for an election that can be made with a degree of retroactive effect to alleviate adverse tax consequences under Part X.2 of the Act associated with the holding of NQI in a "qualified trust" - this election would generally not be available to the funds managed by IFIC members. Those funds do not meet the requirements to be a "qualified trust" under s.259 because (i) they do not have a trustee that is a registered trust company and/or (ii) they offer units of differing series or classes which are not identical to each other. However, s.259 is an example of a provision that recognizes the fairness of considering the underlying unitholders in a trust when applying the tax under Part X.2. This accords with the intent of our proposed legislative amendments set out above.

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Conclusion

IFIC submits that implementing the recommendations proposed in this letter will substantially improve the fairness of the RI and QI regimes by better aligning the application of these rules with their underlying policy intent in a broader range of circumstances that in recent years have become prevalent within the investment fund industry.

We would be pleased to provide additional information or answer any questions you may have. Please feel free to contact James Carman by email at jcarman@ific.ca or, by phone (416) 309-2323.

Yours sincerely,

THE INVESTMENT FUNDS INSTITUTE OF CANADA

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Appendix A – Designated Stock Exchange Recommended Additions

- Abu Dhabi Exchange
- Amman Stock Exchange
- Athens Stock Exchange (ATHEX)
- Bahrain Stock Exchange
- BATS Global Markets
- Beirut Stock Exchange, Lebanon
- Belgrade SE
- BME Spanish Exchanges
- Bolsa de Comercio de Buenos Aires
- Bolsa de Comercio de Santiago
- Bolsa de Valores de Colombia
- Bolsa de Valores de Lima
- Bolsa Mexicana de Valores
- Bombay Stock Exchange
- Borsa İstanbul
- Bourse de Casablanca
- Bourse des Valeurs Mobilieres de Tunis
- BSE India Limited
- Bucharest Stock Exchange
- Budapest Stock Exchange
- Buenos Aires Stock Exchange
- Bulgarian Stock Exchange
- Bursa Malaysia
- Cairo Stock Exchange
- Casablanca Stock Exchange, Morroco
- CBOE Holdings, Inc.
- China Financial Futures Exchange
- CME Group
- Colombo Stock Exchange, Sri Lanka
- Cyprus Stock Exchange
- Dalian Commodity Exchange
- Deutsche Börse AG
- Dhaka Stock Exchange
- Doha Securities Market (Qatar)
- Dubai Financial Market
- Euronext Lisbon
- Hochiminh Stock Exchange, Vietnam
- Hong Kong Exchanges and Clearing
- Indonesia Stock Exchange
- Intercontinental Exchange, Inc.
- International Securities Exchange
- Istanbul Stock Exchange
- Japan Exchange Group, Inc
- Karachi Stock Exchange, Pakistan
- Kazakhstan Stock Exchange
- Kuwait Stock Exchange
- Lahore Stock Exchange
- Malta Stock Exchange
- Mercado Continuo Exchange
- MICEX-RTS, Russia
- Moscow Exchange
- Muscat Securities Market
- Nairobi Stock Exchange, Kenya
- NASDAQ Dubai
- National Stock Exchange of India Limited
- Nigerian Stock Exchange
- NZX Limited
- Oslo Børs
- Osaka Stock Exchange, Japan
- PFTS Stock Exchange, Ukraine
- Phillippine Stock Exchange
- Prague Stock Exchange
- Qatar Stock Exchange
- Rio De Janeiro Stock Exchange, Brazil
- Saudi Stock Exchange (Tadawul)
- Shanghai Futures Exchange
- Saint Petersburg Stock Exchange
- Santiago Stock Exchange
- Sao Paulo Stock Exchange, Brazil
- Shanghai Stock Exchange
- Shenzhen Stock Exchange
- SIX Swiss Exchange
- Stock Exchange of Mauritius
- Taipei Exchange
- Taiwan Futures Exchange
- Taiwan Stock Exchange Corporation
- Tallin Stock Exchange
- Tel-Aviv Stock Exchange
- The Egyptian Stock Exchange
- The Stock Exchange of Thailand, Bangkok
- TMX Group Inc.
- Trinidad and Tobago Stock Exchange
- Tunis Stock Exchange
- Ukrainian Exchange
- Wiener Börse AG (CEE Stock Exchange Group)
- Vilnius Stock Exchange
- VIRT-X Exchange – Swiss
- XETRA Exchange Germany
- Zagreb Stock Exchange
- Zhengzhou Commodity Exchange