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

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Delivered By Email: Consultation-Legislation@fin.gc.ca

Department of Finance Canada
90 Elgin Street
Ottawa, Ontario
K1A 0G5

Dear Sirs and Mesdames:

RE: Proposed Excessive Interest and Financing Expenses Limitation (EIFEL)

We are writing to provide comments on the proposed EIFEL rules contained in draft legislation to amend the *Income Tax Act* (Canada) (the **ITA**) released on February 4, 2022 (**Proposed Rules**). Our comments are directed to the application of the Proposed Rules to mutual funds structured as "unit trusts", "mutual fund trusts" and "mutual fund corporations" as defined in the ITA (collectively **Funds**). Unless otherwise noted, all references to sections and components thereof are to the ITA as it is proposed to be amended by the Proposed Rules.

IFIC is the voice of Canada's investment funds industry. IFIC brings together 150 organizations, including fund managers, distributors and industry service organizations, to foster a strong, stable investment sector where investors can realize their financial goals. IFIC operates on a governance framework that gathers member input through working committees. The recommendations of the working committees are submitted to the IFIC Board or board-level committees for direction and approval. This process results in a submission that reflects the input and direction of a broad range of IFIC members.

Background

Before providing specific comments on the Proposed Rules, it is important to note certain relevant considerations applicable to Funds:

a. Funds permit the collective investment of assets by investors.

b. Securities of a Fund may be distributed to the public pursuant to a prospectus (widely-held Funds) or pursuant to exemptions from the prospectus requirements. Securities are generally offered on a continuous basis and are redeemable on demand. Most securityholders have their securities redeemed by the Fund.

c. Securities of exchange-traded mutual funds (ETFs) are listed on a stock exchange. Securityholders may redeem securities of an ETF but, except for "designated brokers" and other dealers, most securityholders sell their units on the stock exchange. "Designated brokers" and dealers engage in transactions to adjust the supply of ETF securities up or down as needed.

d. The provisions of the ITA are generally intended to apply so that an investor in a Fund is not disadvantaged from a tax perspective by investing through a Fund rather than investing directly.

e. Mutual fund corporations may have a number of classes of shares, each of which is recognized under securities legislation as, or as part of, a separate investment fund.[1] We refer to such investment funds as "**Class Funds**". Except where the context requires, reference to a Fund includes a Class Fund.

f. The manager of a Fund has a fiduciary obligation to the Fund.

g. A manager may manage numerous Funds with different investment objectives and different strategies. A manager usually does not have a material economic interest in the Funds that it manages.

h. A manager may control a mutual fund corporation.

i. A single corporation, which may be a manager or trust company, can be the trustee of a large number of unit trusts and mutual fund trusts.

j. The trustee or manager of a Fund may be related to or affiliated with many other corporations. Such other corporations may carry on business outside Canada or have foreign affiliates.

k. National Instrument 81-102 of the Canadian Securities Administrators (**NI 81-102**) generally applies to (i) a "mutual fund"[2] that offers or has offered securities under a prospectus for so long as the mutual fund remains a reporting issuer, and (ii) a non-redeemable investment fund[3] that is a reporting issuer[4]. A sub-category of "mutual fund" is an "alternative mutual fund", which is a mutual fund, other than a precious metals fund, that has adopted fundamental investment objectives that permit it to invest in physical commodities or specified derivatives, to borrow cash or engage in short selling in a manner not permitted for other mutual funds under NI 81-102. NI 81-102 imposes restrictions on the ability of an investment fund to borrow, to enter into derivative instruments for non-hedging purposes and to enter into repurchase agreements, including:

    i. An investment fund may not borrow cash or provide a security interest over any of its portfolio assets unless the transaction is a temporary measure to accommodate requests for the redemption of securities of the investment fund while the investment fund effects an orderly liquidation of portfolio assets, or to permit the investment fund to settle portfolio transactions and, after giving effect to all such transactions, the outstanding amount of all borrowings of the investment fund does not exceed 5% of its net asset value at the time of the borrowing; notwithstanding the above, an alternative mutual fund and a non-redeemable investment fund may borrow cash subject to certain conditions, including that the value of the cash borrowed cannot exceed 50% of the fund's net asset value;

    ii. In the case of a derivative position entered into for purposes other than for hedging, a mutual fund, other than an alternative mutual fund, is required to hold certain portfolio assets to cover the obligations under the derivative; and

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[1] This is acknowledged in the definition of "qualifying exchange" in subsection 132.2(1).

[2] "Mutual fund" is defined in the *Securities Act* (Ontario) as "an issuer whose primary purpose is to invest money provided by its security holders and whose securities entitle the holder to receive on demand, or within a specified period after demand, an amount computed by reference to the value of a proportionate interest in the whole or in part of the net assets, including a separate fund or trust account, of the issuer"

[3] A "non-redeemable investment fund" is defined in National Instrument 81-106 as an issuer,

(a) whose primary purpose is to invest money provided by its securityholders,

(b) that does not invest,

(i) for the purpose of exercising or seeking to exercise control of an issuer, other than an issuer that is a mutual fund or a non-redeemable investment fund, or

(ii) for the purpose of being actively involved in the management of any issuer in which it invests, other than an issuer that is a mutual fund or a non-redeemable investment fund, and

(c) that is not a mutual fund;

[4] A "reporting issuer" is defined in the *Securities Act* (Ontario) and includes an issuer that has filed a prospectus under that Act and has received a receipt.

iii. In the case of repurchase agreements, the aggregate market value of all securities loaned by an investment fund in securities lending transactions and not yet returned to it or sold by the investment fund in repurchase transactions and not yet repurchased may not exceed 50% of the net asset value of the investment fund.

l. The restrictions in NI 81-102 apply to Canadian ETFs, which are considered to be mutual funds under NI 81-102.

Submissions

Exclusion of Funds

As stated, Funds permit the collective investment of assets by investors. The provisions of the ITA are generally intended to apply so that an investor in a Fund is not disadvantaged from a tax perspective by investing through a Fund rather than investing directly. The vast majority of investors in widely-held funds, the securities of which are distributed to the public pursuant to a prospectus, are individuals (including their RRSPs, RRIFs and TFSAs) or “excluded entities” to which the Proposed Rules do not apply.

In general, those Funds to which NI 81-102 applies will not have substantial borrowings or other interest and financing expenses. Having regard to the technical issues addressed below with respect to the definition of “excluded entity”, many Funds will be unable to establish they are “excluded entities” and it is possible that their status may change from year to year. As a practical matter, this will require such Funds to introduce measures to track all interest and financing expenses and then test that amount against interest and financing income and adjusted taxable income. These amounts are not currently calculated.

A mutual fund trust generally distributes all of its income and net realized capital gains (after taking into account the capital gains refund) for a taxation year to its unitholders before the end of the taxation year (or between December 15 and December 31 if it has elected to have a December 15 tax year end). The calculations required by the Proposed Rules will have to be completed before the end of the taxation year (or between December 15 and December 31 if it has elected to have a December 15 tax year end) in order to determine if there is additional income caused by a denial of interest and financing expenses that must be made payable to unitholders. Mutual fund trusts will need to incur this administrative burden even though the Proposed Rules would not apply to deny any interest and financing expense in almost all cases. A bright line exclusion for them as described below would alleviate this burden without material risk of base erosion.

Accordingly, from a policy perspective we submit that it is appropriate to exclude the following from the application of the Proposed Rules:

a. A mutual fund trust (or a trust that would be a mutual fund trust if it satisfied the condition in paragraph (c) of subsection 132(6)) that is a mutual fund that is subject to, and substantially complies with, the requirements of NI 81-102 as amended;

b. A mutual fund corporation that is a mutual fund that is subject to, and substantially complies with, the requirements of NI 81-102 as amended; and

c. A mutual fund corporation comprised of a number of Class Funds, each of which is a mutual fund that is subject to, and substantially complies with, the requirements of NI 81-102 as amended.

We would also note that from a policy perspective and for the reasons discussed below under the International Competitiveness sub-heading, consideration should also be given to excluding all investment funds, including those that are not subject to the requirements of NI 81-102.

International Competitiveness

The exclusions we are requesting to the Proposed Rules would be consistent with the approach that a number of countries have taken with respect to the implementation of BEPS Action 4. In particular, we would note that several European countries have exempted certain “financial undertakings” from the scope

of their interest deduction limitation rules. Such exclusions are consistent with recital 9 to the EU Anti-Tax Avoidance Directive 2016/1164 (the "ATAD") that states:

> Although it is generally accepted that financial undertakings, i.e. financial institutions and insurance undertakings, should also be subject to limitations to the deductibility of interest, it is equally acknowledged that these two sectors present special features which call for a more customised approach. As the discussions in this field were not sufficiently conclusive in the international and the Union context, it is not possible to provide specific rules in the financial and insurance sectors and Member States should therefore be able to exclude them from the scope of interest limitation rules.

Article 4(7) of the ATAD provides that member states may exempt certain "financial undertakings" within the meaning of Article 2(1) of the ATDA.[5] Finland, for example, has chosen to exempt the following financial undertakings:

- Credit institutions;
- Investment firms;
- Alternative investment funds and their managers;
- Undertakings for a collective investment in transferable securities and their management companies; and
- Insurance companies.[6]

We would also note there is a carve out in the UK for Authorised Investment Funds ("AIFs") and Investment Trust Companies.[7]

Technical Comments

We have a number of technical comments with respect to the definitions of "eligible group entity", "excluded entity" and "adjusted taxable income".

<u>"Eligible Group Entity"</u>

With respect to paragraph (a) of the definition of "eligible group entity", we are concerned that the CRA may take the view that two mutual fund trusts with the same trustee are an "eligible group entity" in respect of each other merely because they have the same trustee even though they would not be affiliated with each other.

Two trusts would not be affiliated with each other merely because they have the same trustee. In the context of the definition of "affiliated persons", paragraph 251.1(4)(c) provides that, notwithstanding subsection 104(1), a reference to a trust does not include a reference to the trustee or other persons who own or control the trust property. The provision was added to address the concern that subsection 104(1) may embody a trust in its trustee for the purposes of the affiliation rules such that every trust with the same trustee would be affiliated for the purposes of the suspended loss rules. The Explanatory Notes to the amendment (and other amendments addressing trusts) state that the effects of this rule are that two trusts are not affiliated simply because they share the same trustee, and a person is not affiliated with a trust simply because that person is affiliated with the trustee of the trust.

However, there is no rule comparable to paragraph 251.1(4)(c) that applies for the purpose of the definition of "related persons". Subsection 104 (1) provides that a reference to a trust or estate in the ITA shall, unless

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5 See Annex "A" attached hereto for full text of that definition.

6 Antti Lehtimaja and Sanna Lindqvist, "2019 Welcomes New Finnish Interest Deduction Limitations" (2019): http://publications.ruchelaw.com/news/2019-01/Finnish-Interest-Deduction.pdf

7 See https://www.gov.uk/hmrc-internal-manuals/corporate-finance-manual/cfm95697

the context otherwise requires, be read to include a reference to the trustee, executor, administrator, liquidator of a succession, heir, or other legal representative having ownership or control of the trust property. The CRA has taken the position that a trust is related to each person related to the trustee of the trust.[8] The only relevant case is *Wright Estate v. The Queen*[9] in which the Court stated that the relevant provisions of the ITA "created a new person, a trust, which is related to no one."

Thus, even though two mutual fund trusts with the same trustee are not affiliated merely because they have the same trustee, we are concerned that CRA may take the view that they are related. Although we contend that this is not appropriate, the uncertainty in this area may create additional uncertainty under the Proposed Rules.

"Excluded Entity"

With respect to paragraph (c) of the definition of "excluded entity", we have the following comments:

a. Clause (c)(i)(A) requires that all or substantially all of each business of the taxpayer be carried on in Canada. Most Funds take the position that they do not carry on a business. In this regard, we note that the ITA requires that the undertaking of a mutual fund trust or mutual fund corporation be limited to the investing of its funds in property (other than real property) and certain permitted activities in relation to real property. We assume that it is intended that, if the taxpayer does not carry on any business, the requirement in clause (c)(i)(A) is satisfied. **We request that the opening language of subparagraph (c)(i) be modified to read "all or substantially all of each business, *if any*, of…" to make this clear.**

b. In respect of mutual fund corporations, it is common for the investment manager to control a mutual fund corporation through the ownership of voting shares that have nominal economic entitlement. The investment manager would be related to the mutual fund corporation and therefore would be an "eligible group entity" in respect of the mutual fund corporation. Each corporation related to the investment fund manager would be related to the mutual fund corporation and would also be an eligible group entity in respect of the mutual fund corporation. If any corporation related to the investment manager were to carry on a business, all or substantially all of which was not carried on in Canada, the test in clause (c)(i)(B) would not be satisfied. **We submit that, in applying clause (c)(i)(B) to a mutual fund corporation, the activities of eligible group entities should be disregarded.**

c. Subparagraph (c)(ii) requires that no corporation be a foreign affiliate of the taxpayer or an eligible group entity. In the situation described in paragraph (b) above, if the investment manager or any corporation related to the investment manager were to own shares of a foreign affiliate, the test in subparagraph (c)(ii) would not be satisfied. **We submit that, in applying subparagraph (c)(ii) to a mutual fund corporation, the ownership of foreign affiliates by eligible group entities should be disregarded.**

d. Subparagraph (c)(iv) requires that all or substantially all of the interest and financing expenses of the taxpayer, and of each eligible group entity, are paid or payable to persons or partnerships that are not at any time in the year tax-indifferent investors (which includes non-residents and tax-exempts). For many Funds, the interest and financing expense of the Fund will consist primarily of spread under repurchase agreements and the cost of leverage on equity swaps. To comply with the requirement in subparagraph (c)(iv), Funds would have to limit the counterparties to their transactions in derivatives and repurchase agreements to taxable Canadian entities. This is not practical for many reasons including that securities lending (including repurchase agreements) by Funds is often outsourced. **We submit that subparagraph (c)(iv) be deleted.**

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[8] See, for example, CRA doc. 2001-0019525.

[9] 96 DTC 1509 (TCC).

“Adjusted Taxable Income”

We believe that, in the determination of adjusted taxable income, paragraph (e) of the description of C is not appropriate.

Consider the following example:

> Trust 1 owns 100% of the units of Trust 2
>
> Trust 2 has $100 of income, all of which is made payable to Trust 1, and deducted under subsection 104(6).
>
> Trust 1 has no other income except the $100 payable to it by Trust 2 that is included in income under subsection 104(13). Trust 1 has interest and financing expenses of $30.
>
> Trust 1 makes $70 payable to its beneficiaries.

The adjusted taxable income of Trust 2 will be $100 (i.e., its taxable income (nil) plus the amount deducted under subsection 104(6), $100, which is added back by paragraph (f) of the description of B).

The adjusted taxable income of Trust 1 will be nil (i.e., its taxable income (nil), plus the amount of its interest and financing expenses ($30) added back by paragraph (a) of the description of B, plus the amount deducted under subsection 104(6), $70, which is added back by paragraph (f) of the description of B, less $100, which is deducted by paragraph (e) of the description of C).

Thus, it appears that some part of the $30 interest and financing expenses will not be deductible which seems to be inappropriate.

Members of our Taxation Working Group would be pleased to discuss our submissions with you.

Yours sincerely,

THE INVESTMENT FUNDS INSTITUTE OF CANADA

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cc: Trevor McGowan, Director General, Finance Canada (Trevor.McGowan@fin.gc.ca)

ANNEX A

'financial undertaking' means any of the following entities:

(a) a credit institution or an investment firm as defined in point (1) of Article 4(1) of Directive 2004/39/EC of the European Parliament and of the Council or an alternative investment fund manager (AIFM) as defined in point (b) of Article 4(1) of Directive 2011/61/EU of the European Parliament and of the Council or an undertaking for collective investment in transferable securities (UCITS) management company as defined in point (b) of Article 2(1) of Directive 2009/65/EC of the European Parliament and of the Council;

(b) an insurance undertaking as defined in point (1) of Article 13 of Directive 2009/138/EC of the European Parliament and of the Council;

(c) a reinsurance undertaking as defined in point (4) of Article 13 of Directive 2009/138/EC;

(d) an institution for occupational retirement provision falling within the scope of Directive 2003/41/EC of the European Parliament and of the Council, unless a Member State has chosen not to apply that Directive in whole or in part to that institution in accordance with Article 5 of that Directive or the delegate of an institution for occupational retirement provision as referred to in Article 19(1) of that Directive;

(e) pension institutions operating pension schemes which are considered to be social security schemes covered by Regulation (EC) No 883/2004 of the European Parliament and of the Council and Regulation (EC) No 987/2009 of the European Parliament and of the Council as well as any legal entity set up for the purpose of investment of such schemes;

(f) an alternative investment fund (AIF) managed by an AIFM as defined in point (b) of Article 4(1) of Directive 2011/61/EU or an AIF supervised under the applicable national law;

(g) UCITS in the meaning of Article 1(2) of Directive 2009/65/EC;

(h) a central counterparty as defined in point (1) of Article 2 of Regulation (EU) No 648/2012 of the European Parliament and of the Council;

(i) a central securities depository as defined in point (1) of Article 2(1) of Regulation (EU) No 909/2014 of the European Parliament and of the Council.