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

Canadian ETF Association

September 8, 2023

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

Tax Policy Branch – Tax Legislation Division
Finance Canada
90 Elgin Street
Ottawa, ON K1A 0G5

Dear Sirs and Mesdames:

RE: Proposed Share Buyback Tax and Exchange-Traded Funds

Further to our discussion on August 21, 2023, we are writing to ask the Department of Finance ("**Finance**") to provide relief for investors in Canadian exchange-traded funds ("**ETFs**") from the impact of the proposed Share Buyback Tax ("**SBT**") in proposed section 183.3 of the *Income Tax Act* (Canada) (the "**Act**").[1]

The Canadian ETF Association ("**CETFA**") represents Canadian managers of ETFs and other participants in the ETF industry in Canada. The Investment Funds Institute of Canada ("**IFIC**") is the voice of Canada's retail mutual fund industry. CETFA and IFIC ("**we**") bring together Canadian fund managers, distributors and service providers to foster a strong, stable investment sector where Canadian investors can realize their financial goals.

For the reasons discussed in further detail herein, the application of the SBT to ETFs interferes with the longstanding scheme of the Act for taxing investment funds and we believe such application is inconsistent with Finance's stated policy behind the SBT, and therefore request that ETFs be excluded from the application of the SBT.

In this submission, we (i) provide an overview of ETFs, including a description of how ETF units are subscribed for and redeemed, (ii) describe how the SBT could apply to certain ETFs, (iii) set out the reasons why we believe such application to be unjustified as a matter of tax policy, and (iv) state the relief being requested.

Executive Summary

ETF structure

ETFs are open-ended mutual funds listed on a stock exchange, designed for retail investors, and they invest in a portfolio of securities. ETFs do not operate businesses or hold real estate.

Typically established as trusts, ETFs issue units that are traded on Canadian stock exchanges. Investors buy and sell ETF units on a stock exchange, and do not transact directly with the ETF. ETFs instead issue units directly to certain market makers, and redeem units from such market makers.

Application of the SBT to ETFs

Under the SBT rules, listed trusts meeting specific criteria, including modified SIFT conditions, could be subject to SBT. ETFs that invest in foreign issuers that derive most of their value from real estate can fall into the modified SIFT category.

1 All statutory references herein are to the provisions of the Act unless otherwise noted.

SBT is intended to impose a 2% tax on *net* equity repurchases; however, anomalously for ETFs that are subject to SBT, in-kind redemptions increase SBT, but in-kind subscriptions do not decrease SBT.

SBT's application to ETFs is unjustified as a matter of tax policy

(a) Inconsistency with SBT Tax Policy

The SBT's two stated policy reasons are: (i) ensuring large corporations pay their fair share and (ii) encouraging them to reinvest profits in workers and in Canada. However, applying the SBT to ETFs is not consistent with these policy objectives.

Firstly, the fair share rationale is inapplicable to ETFs. Like any other mutual fund, ETFs generally do not pay entity-level tax, and their income is instead taxed in their investors' hands. Introducing a new layer of potential tax at the level of an ETF therefore would not reinstate ETFs to some perceived "fair" target amount of tax the fund should pay.

Secondly, the reinvestment rationale assumes that ETFs have an operating business and workers to reinvest profits in. However, ETFs have no employees, they do not carry on an operating business, and they cannot control issuers that carry on an operating business. Additionally, even if the businesses of the issuers in a global real estate ETF's portfolio were considered, they would generally be outside of Canada.

Also, applying the SBT to ETFs is inconsistent with the corresponding stock buyback tax introduced in the United States. Their government exempted regulated investment companies (RICs), which include substantially all US ETFs, from the stock buyback tax.

(b) Inconsistency with Investment Funds Tax Policy

Additionally, applying the SBT to ETFs would interfere with the general scheme of the Act for taxing investment funds and their investors. The Act aims to ensure that income generated from investments is subject to tax only once, either at the fund level or the investor level, to prevent double taxation and promote fairness. Applying an entity-level tax to ETFs would introduce an alien tax that disrupts this scheme and eliminates tax neutrality between investing directly and investing through an investment fund.

In summary, applying the SBT to ETFs is inconsistent with the policy objectives of the SBT. Furthermore, it would disrupt the general scheme for taxing investment funds and eliminate tax neutrality, all while reducing the value of the holdings of Canadian retail investors.

Requested Relief

We request that the SBT not apply to a trust that has units listed on a designated stock exchange in Canada, and in continuous distribution.

Overview of ETFs

An ETF is an open-ended mutual fund listed on a stock exchange, established for the benefit of retail investors, that invests in a portfolio of securities. ETFs in Canada are typically formed as trusts that are resident in Canada for purposes of the Act. Units of the trust are distributed to retail investors under a prospectus filed with the appropriate securities' regulatory authorities and trade on a stock exchange (in Canada, the Toronto Stock Exchange (the "**TSX**") or CBOE Canada (previously known as NEO Exchange)) (collectively referred to as "**Exchanges**"). The most common way for an investor to divest of ETF units is by selling the units on the exchange.

Canadian ETFs generally either qualify as mutual fund trusts (as defined in subsection 132(6)) or, in some cases, would so qualify if they satisfied prescribed conditions relating to the number of their unit holders.[2] In either case, Canadian ETFs are operated so as to comply with the condition in paragraph 132(6)(a) that

[2] The requirement to comply with "prescribed conditions" is in paragraph 132(6)(c), and the prescribed condition that relates to number of unitholders is in paragraph 4801(b) of the *Income Tax Regulations* (Canada).

the trust limit its undertaking to investing its funds in property (other than real property).[3] Furthermore, the portfolios of Canadian ETFs do not include direct holdings in real estate or resource properties. Canadian ETFs would only have exposure to these asset classes by investing in issuers whose securities derive their value from real or resource properties. For example, as discussed in more detail below, an ETF may hold a diversified portfolio of minority positions in companies and other issuers that invest in global real estate.

The Act's requirement that ETFs generally limit their activities to investing is further reinforced by Canadian securities regulations (the "**Securities Regulations**"), which contain certain investment restrictions applicable to mutual funds, which restrict an ETF from (a) buying securities of an issuer if, immediately after the purchase, the ETF would hold securities representing more than 10% of the (i) votes attached to the outstanding voting securities of that issuer; or (ii) the outstanding equity securities of that issuer, unless an exemption is obtained; or (b) purchasing a security for the purpose of exercising control over, or management of, the issuer. The Ontario Securities Commission is of the view that engaging in an operating business, or an extension of an operating business, is inconsistent with the nature of an investment fund.[4]

Of relevance to the SBT is the fact that frequent, often daily, ETF unit redemptions are integral to the way that ETFs function. In general, the only market participants who can subscribe for ETF units and who request to redeem ETF units[5] are certain participating broker-dealers ("**Authorized Participants**" or "**APs**"[6]) who have entered into a designated broker or dealer agreement to allow them to subscribe for and redeem ETF units in "bulk", in each case in exchange for either:

(a) a "basket" of the underlying securities comprising the ETF portfolio (a "**Basket of Securities**"),

(b) cash or

(c) a combination of portfolio securities and cash.

Typically, as part of a subscription for ETF units, an Authorized Participant would transfer a Basket of Securities to the ETF and/or cash in exchange for ETF units. Conversely, to redeem units the ETF would transfer a Basket of Securities and/or cash to the broker-dealer in satisfaction of the redemption proceeds owing to the AP. See the diagram at Appendix A.

The role of Authorized Participants as market makers is, in conformity with the Exchanges' rules, to maintain a fair, orderly and continuous two-sided market in the units of the ETF.[7]

In performing their market-making function, Authorized Participants transact with two different types of parties: (i) buyers and sellers of ETF units on the Exchanges, and (ii) the ETF.

> *Secondary-Market AP Activity*: An Authorized Participant's interactions with secondary market investors (i.e., those investors who buy and sell on the exchange) is similar to those of a market maker in an ordinary listed stock of a particular company. That is, an Authorized Participant that is a market maker must commit to continuously quoting prices at which it will buy (or bid for) and sell (or ask for) a particular ETF's units. It must also quote the volume of units in which it is willing to trade. Once a buy (or sell) order is received from a buyer (or seller) within the bid/ask and volume

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[3] Paragraph 132(6)(a) requires that the trust limit its undertaking to (i) the investing of its funds in property (other than real property), and/or (ii) the acquiring, holding, maintaining, improving, leasing or managing of any real property that is capital property. As discussed below, ETFs do not engage in the activities listed in (ii).

[4] OSC Staff Notice: 81-722 - *Mortgage Investment Entities and Investment Funds*.

[5] An investor who holds units of an ETF would have a right to have the units redeemed by the fund in exchange for cash, albeit at a discount to net asset value that makes it more likely, in normal market conditions, that the investor will exit its investment by selling on the secondary market. An investor who holds a prescribed minimum number of units would have a right to have the units be redeemed by the fund, at net asset value, in exchange for a "basket" of the underlying securities comprising the ETF portfolio or cash or both (typically in the manager's discretion).

[6] The Authorized Participants were regulated by Investment Industry Regulatory Organization of Canada (IIROC) prior to January 1st, 2023 and now by Canadian Investment Regulatory Organization (CIRO) as of January 1st, 2023.

[7] One subset of Authorized Participants are designated brokers, who assume/enjoy additional burdens and benefits under the Exchanges' rules in connection with maintaining an orderly two-way market.

parameters quoted, an Authorized Participant immediately sells units from its own inventory (or buys units to hold in its own inventory), in order to complete the order. Authorized Participants make most of their ETF activity-related revenue/profits from this secondary market activity, in the form of bid/ask spreads, fee rebates (from the exchange) and trading commissions.

Primary-Market AP Activity: Authorized Participants also transact directly with the ETF in order to create new units (that are sold into the secondary market) and to redeem existing units (purchased from the secondary market). The APs' activity of creating and redeeming units is central to their role in ensuring the liquidity of investors' holdings of ETFs by balancing supply and demand of ETF units. In addition, APs provide pricing transparency and mitigate adverse market impact to investors by continuously engaging in trades that reduce the difference between an ETF's trading price and its net asset value, thereby leading to tighter bid/ask spreads, which again ensures a more liquid market.[8]

Application of the SBT to ETFs

In this section we explain how the SBT can apply to certain ETFs.

The SBT applies to a trust that is a "covered entity", as defined in proposed subsection 183.3(1). A trust is a covered entity for a taxation year if at any time in the taxation year:

(a) equity of the trust is listed on a designated stock exchange; and

(b)(i) the trust is a mutual fund trust that

(A) is a real estate investment trust (as defined in subsection 122.1(1)),

(B) is a SIFT trust, or

(C) would be a SIFT trust if

(I) each reference in paragraph (a) of the definition non-portfolio property in subsection 122.1(1) to "subject entity" were read as "corporation, partnership or trust" and paragraph (c) of that definition were read without reference to the words "in Canada",

(II) paragraph (a) of the definition Canadian real, immovable or resource property in subsection 248(1) were read without reference to the words "situated in Canada", and

(III) the definitions timber resource property in subsection 13(21) and Canadian resource property in subsection 66(15) were read without references to the words "in Canada".

We refer in this letter to the modification effected by subclause C(II) of the definition of a covered entity as the "**C(II) Modification**".

ETFs are not real estate investment trusts (as defined in subsection 122.1(1)). Further, ETFs are not typically SIFT trusts. However, global real estate ETFs (each, a "**GRE**" ETF) and other ETFs that invest in

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8 In this regard, APs are a subset of a broader category of market makers that contribute to the liquidity and depth of the market for TSX-listed securities. See information on the "Market Maker System" on the TSX website (at http://www.tmx.com/en/trading/products_services/market_system.html): "The role of the Market Maker on Toronto Stock Exchange (TSX) is to augment liquidity, while maintaining the primacy of an order-driven continuous auction market based on price-time priority. ... TSX Market Maker responsibilities [include the following:]

- Call a 2-sided market providing market continuity within a pre-specified range
- Contribute to market liquidity and depth
- Maintain activity in the market...".

See also TSX Rule 4-604 Responsibilities of Market Makers.

portfolio companies that hold foreign real or resource property, such as in the infrastructure or mining industries, could be covered by (C) above, specifically (C)(II).[9]

A GRE ETF does not hold real estate directly, and typically holds a diversified portfolio of companies and other issuers that hold real estate situated primarily or entirely outside Canada. However, in accordance with the Securities Regulations discussed above, a GRE ETF would hold a small, non-controlling interest in each of the companies in its portfolio. While perhaps unintuitive, these small positions in real estate issuers could result in the GRE ETF being a SIFT trust, as modified by the C(II) Modification.

A trust is a SIFT trust, as defined in subsection 122.1(1) for a taxation year, if at any time during the year:

> (a) the trust is resident in Canada;
>
> (b) investments in the trust are listed or traded on a stock exchange or other public market; and
>
> (c) the trust holds one or more non-portfolio properties.

An ETF, including a GRE ETF, would meet the conditions in (a) and (b) above. Without the application of the C(II) Modification, however, a GRE ETF would not meet the condition in (c) above.

The C(II) Modification operates to turn the types of securities held by GRE ETFs into "bad" assets, i.e., the kind that cause a trust to be a covered entity. Under paragraph (b) of the definition in subsection 122.1, "non-portfolio property" of a trust is defined to include a "Canadian real, immovable or resource property" ("**CRIRP**"), if at any time in the taxation year the total fair market value of all properties held by the trust that are Canadian real, immovable or resource properties is greater than 50% of the equity value of the trust.

Under the definition in subsection 248(1), a CRIRP means

> (a) a property that would, if this Act were read without reference to the definition "real or immovable property" in subsection 122.1(1), be a real or immovable property situated in Canada,
>
> (b) a Canadian resource property,
>
> (c) a timber resource property,
>
> (d) a share of the capital stock of a corporation, an income or a capital interest in a trust or an interest in a partnership—other than a taxable Canadian corporation, a SIFT trust (determined without reference to subsection 122.1(2)), a SIFT partnership (determined without reference to subsection 197(8)) or a real estate investment trust (as defined in subsection 122.1(1))—if more than 50% of the fair market value of the share or interest is derived directly or indirectly from one or any combination of properties described in paragraphs (a) to (c), or
>
> (e) any right to or interest in—or, for civil law, any right to or in—any property described in any of paragraphs (a) to (d);

Before describing how the CRIRP definition, as altered by the C(II) Modification, applies to GRE ETFs, it is helpful to consider how the CRIRP definition (whether modified or unmodified) applies to ETFs that hold securities that derive most of their value from real estate situated in Canada (a "**Canadian RE ETF**"). A Canadian RE ETF would generally not hold any CRIRP because most if not all of the issuers of such securities would be expected to be excluded from the CRIRP definition. Paragraph (d) of the CRIRP definition carves out taxable Canadian corporations, SIFT trusts, SIFT partnerships and real estate

[9] While the analysis of a GRE ETF may apply equally to an ETF that invests in foreign infrastructure or mining companies, we have referred only to a GRE ETF for simplicity. Also, by "global" we mean simply foreign or non-Canadian, such that an ETF that focuses only on U.S. real estate or only on European real estate, for example, would be a GRE ETF for purposes of this discussion.

investment trusts. A notable aspect of the carve-outs in paragraph (d) is that none of them apply to entities that are not resident in Canada.[10]

As discussed in greater detail at Appendix B, the legislative history of the CRIRP definition demonstrates that a deliberate choice was made to exempt publicly-traded investment funds from being considered to hold CRIRP simply because they invest in issuers that derive their value mainly from Canadian real or resource property. The means chosen to achieve this policy objective was to create carve-outs for Canadian resident entities that themselves had been determined to bear the right level of entity-level tax, such that an investment fund holding them should not itself be considered to be a SIFT trust.

By removing the words "situated in Canada", but without eliminating the Canadian residence condition in the carve-outs, the (C)(II) Modification results in a modified CRIRP definition that reflects none of the previously made policy choices regarding excluded issuers. The result is a modified CRIRP definition that would be expected to apply to most securities held by a GRE ETF, since such securities will generally:

(a) meet the condition in paragraph (d) of the modified CRIRP definition of deriving more than 50% of their fair market value from real or resource property anywhere in the world, but
(b) not meet the Canadian residence condition in the paragraph (d) carve-outs.

Consequently, the constituent securities in the portfolio of a GRE ETF will be non-portfolio property meaning that the GRE ETF is a covered entity that is subject to the SBT.

In addition, an ETF could also be a covered entity as a result of inadvertently holding property that is non-portfolio property. For example, subparagraph (a)(i) of the definition of non-portfolio property refers to a property held by a trust that is a security of a "subject entity" if the trust holds securities of the subject entity representing more than 10% of the equity value of the subject entity. Under the SIFT rules, if an ETF inadvertently held such a property, which would admittedly be exceedingly rare due to the Securities Regulations, the ETF would only be subject to tax under the SIFT rules on its income from such property (rather than its income from its investments generally). However, under the SBT, the ETF would be a covered entity and would be subject to the SBT in respect of all redemptions for the entire year.

The SBT results of ETFs being covered entities are anomalous. Pursuant to proposed subsection 183.3(2), an ETF that is a covered entity is generally subject to a 2% tax on the amount, if any, by which the total fair market value of equity of the ETF that is redeemed, acquired or cancelled (other than by a reorganization or acquisition transaction (a "**ROAT**")) in the taxation year by the covered entity exceeds the total fair market value of equity of the covered entity that is issued (other than in the course of a ROAT) in the taxation year.

A ROAT of an ETF that is a covered entity would not include a redemption that is not for cash; however, a ROAT of an ETF is generally defined to include an issuance of units of the ETF that is not for cash. In other words, in kind redemptions of ETF units by an AP increase the amount of the SBT, but in-kind subscriptions for ETF units by an AP do not decrease the amount of the SBT. This result seems completely inappropriate from a policy perspective.

Why Application of the SBT to ETFs is Inconsistent with the Policy Behind the Proposed SBT and Behind the Current Scheme of the Act Applicable to Investment Funds

The application of the SBT to ETFs is inconsistent with the policy rationale for the SBT stated in the 2022 Fall Economic Statement ("**FES**"). The FES stated such policy as follows:

> We're taxing share buybacks, to make sure that large corporations pay their fair share, and to encourage them to reinvest their profits in workers and in Canada.

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[10] Although the Act does not generally treat partnerships as resident anywhere, one of the conditions imposed by subsection 197(1) for a partnership to be a SIFT partnership is that it be a "Canadian resident partnership", which is a defined term in subsection 248(1) that was specifically created for the SIFT rules.

This sentence posits two reasons for introducing the SBT: (i) ensuring large corporations pay their fair share, and (ii) encouraging large corporations to reinvest their profits in workers and in Canada.

Fair Share

With respect to the fair share rationale, there has been a long-standing policy in the Act for collective investment vehicles, like ETFs, to be taxed in the same manner as if the investors in the vehicle directly held the assets of the vehicle directly. If the investors in a GRE ETF directly held the constituent securities of the ETF, the SBT would not apply at the level of the investor, as there would be no security to be redeemed or purchased for cancellation (other than the securities of the constituent issuers, and the application of the SBT would be the same regardless of whether such securities would be held directly by the investors or by the GRE ETF). Accordingly, introducing another layer of potential SBT, at the level of the GRE ETF, is inconsistent with the requirement to pay a "fair share", and potentially discourages investors from investing in ETFs as compared to investing directly or investing in other investment vehicles.

Reinvest Profits in Workers and in Canada

*C*onsistent with the Securities Regulations, ETFs do not carry on an operating business and cannot control issuers that carry on an operating business. Accordingly, there is no business, and no workers, of an ETF or controlled by the ETF to reinvest the ETF's profits (which profits are simply dividends or other distributions from the ETF's portfolio securities).

Further, in the context of a GRE ETF, even the businesses of the issuers in the portfolio of the ETF would generally not be in Canada. Accordingly, even if one were to say that a GRE ETF should reinvest its profits into the businesses of the issuers of its portfolio securities, those businesses would invariably be located outside of Canada. This is because if those businesses were located in Canada, the issuers would likely be structured as a "taxable Canadian corporation", a SIFT trust (determined without reference to subsection 122.1(2)), a SIFT partnership (determined without reference to subsection 197(8)) or a real estate investment trust (as defined in subsection 122.1(1)), and therefore excluded from the definition of CRIRP.

We submit that there is no justifiable policy reason for the SBT to apply to a trust that makes portfolio investments (i.e., taking usually far less than 10% positions) in foreign issuers that own foreign real estate or that operate mines in foreign countries (such as foreign issuers like Exxon Mobil Corp. or BHP Billiton Limited). Presumably, the reason for including paragraph (d) in the definition of CRIRP as it applies for the purpose of defining a SIFT trust is to prevent a trust from investing indirectly in Canadian real property or resource property through a corporation or trust and – as discussed at Appendix B – the reason for carving out a taxable Canadian corporation, a SIFT Trust or a REIT in paragraph (d) is to allow an investment trust which would otherwise be a SIFT trust to invest indirectly in real property or resource property through an "acceptable" vehicle while investments in these "acceptable" vehicles would still be subject to the limits in paragraph (a) in the definition of "non-portfolio property". The same policy concerns do not appear to apply in the context of the SBT. Singling out funds that invest in these sectors appears to be arbitrary.

Compliance Burden and Additional Policy Considerations

Also, it would be difficult in practice for trusts that make portfolio investments in foreign issuers to determine whether more than 50% of the fair market value of the securities of such issuers is derived from real or resource property or interests in such properties. The new definition of a covered entity will require the development of new systems to ensure compliance with these additional restrictions on a continuous basis, which will involve significant cost. Further, publicly available information such as consolidated financial statements of public issuers do not contain all of the information that is required in order to make this determination. Accordingly, it may not even be possible for managers of ETFs to ensure compliance in certain cases.

Lastly, the SBT appears intended to change the behaviour of public issuers by disincentivizing share buybacks. Accordingly, it is inherent in the rationale behind the SBT that an issuer controls whether it redeems or purchases for cancellation its securities, and therefore controls whether it is subject to the SBT. However, this is not the case for an ETF. As discussed above, an ETF unit is redeemable at the option of the holder of the unit. More specifically, in practice most ETF redemptions are initiated by an AP. The role of the ETF is simply the process the redemption, in accordance with the terms of its governing declaration of trust. Accordingly, the inherent rationale for the SBT to change the behaviour of public issuers does not apply with respect to ETFs.

In summary, for the reasons stated above, applying the SBT to ETFs does not accord with the policy objective of the SBT.

Application of SBT to ETFs is Inconsistent with Corresponding US Stock Buyback Tax

The application of the SBT to ETFs is also inconsistent with the corresponding stock buyback tax introduced in the United States. The FES stated that the SBT would be "similar to a recent measure introduced in the United States", suggesting that the SBT was inspired at least in part by the corresponding US tax. Following submissions made to the US Department of the Treasury ("**Treasury**") by the Investment Company Institute stating that it would be inappropriate for the stock buyback tax to apply to ETFs and other investment funds (attached as Exhibit A), Treasury exempted "regulated investment companies" ("**RICs**") from the stock buyback tax. As virtually all US ETFs qualify as RICs, this exemption effectively exempted all ETFs from the application of the stock buyback tax.

Application of SBT to ETFs is Inconsistent with the Act's Regime for Taxing Investment Funds

Further, in addition to the application of the SBT to ETFs not according with the policy of the SBT, the application of an entity-level tax to an investment fund trust like an ETF would also interfere with and run counter to the general scheme of the Act for such trusts and their investors. Provisions like subsection 104(6) (deduction for distributions), section 132 (capital gains refund mechanism) and the designations in section 104 to preserve the character of Canadian taxable dividends, capital gains and foreign source income when distributed to beneficiaries (investors) are instances of a general Canadian tax policy of ensuring that income generated from investments is subject to tax only once, either at the fund level or the investor level. This policy aims to prevent double taxation and promote fairness in the taxation of investment income. While the SBT is not itself a tax on income, it would introduce an entity-level tax that is alien to this scheme of creating tax neutrality as between:

(i) investing in a portfolio of securities directly, and

(ii) investing in the same portfolio indirectly through an investment fund organized as a trust.

Parliament has decided that the latter option, which brings with it economies of scale and other efficiencies for small investors, should generally not result in more tax than the former option. The application of an SBT to a GRE ETF would arbitrarily eliminate such tax neutrality for one particular kind of collective investment vehicle.

Indeed, when one considers the very transaction of a GRE ETF that SBT would apply to, namely, unit redemptions, it is clear that Parliament has already taken into account the way that APs redeem units and determined what it currently believes is the "right" level of taxation to apply to such redemptions. First, as a general matter, Parliament does not intend for redemptions of mutual fund trust units to result in double taxation. On May 8, 2001, when Parliament was considering a specific amendment to the capital gains refund mechanism, a member of the House of Commons in hearings before the Standing Committee on Finance stated that: "this provision ensures that there is no double taxation of capital gains realized by mutual funds and trusts, so that you're not taxing it in the fund and again in the hands of the taxpayer."[11] Similarly, Technical Notes to section 132 released in 2001 state that the role of the CGRM is "to avoid double taxation".[12] However, in 2022, Parliament introduced a rule that was understood to potentially result in some tax leakage (entity-level tax) in respect of redemptions of ETFs. Subsection 132(5.31) was added that year to create a formula-based limit to the subsection 104(6) deduction by an ETF of certain amounts allocated to unitholders that have redeemed units. The Department of Finance developed this formula-based approach after years-long discussions with industry, including IFIC and CETFA that described

11 Standing Committee on Finance, Evidence (8 May 2001) at 1000 [presented during a meeting on Bill C-22, 37th Parliament, 1st Session].

12 Canada, Department of Finance, Explanatory Notes Relating to Income Tax (Ottawa: Department of Finance, March 16, 2001).

mechanics of frequent and large-volume ETF redemptions by APs. The result is a rule that will result in some circumstances in ETFs having to pay entity-level tax in connection with gains realized on in-kind transfers of portfolio securities to redeeming unitholders. The Government of Canada, in other words, long before the SBT has already given extensive consideration to an appropriate level of taxation that ought to be borne by ETF redemptions within their unique context. Adding an SBT toll charge on top of the mechanism of subsection 132(5.31) would result in parallel, overlapping but uncoordinated rules that would bring policy disarray to the Act's longstanding scheme for taxing investment funds – not to mention reducing the value of units held by retail investors saving for retirement, education, and similar goals.

Requested Relief

We are requesting that Finance exclude ETFs from the definition of a "covered entity" for purposes of the SBT.

More specifically, we request that the definition of a covered entity be modified to exclude a "unit trust" (as defined in subsection 108(2)) that is resident in Canada for purposes of the Act and that has one or more classes of units that are listed on a designated stock exchange in Canada and are in continuous distribution.

Our request aligns with the definition of ETF units in subsection 132(5.31).

Conclusion

We thank the Department of Finance for considering our submission, and we are available to meet with you at your convenience should you wish to discuss any aspect of the above further. To set up a meeting or if you have further questions, please do not hesitate to contact either of the undersigned, at PatDunwoody@cetfa.ca and jbaillargeon@ific.ca.

Yours sincerely,

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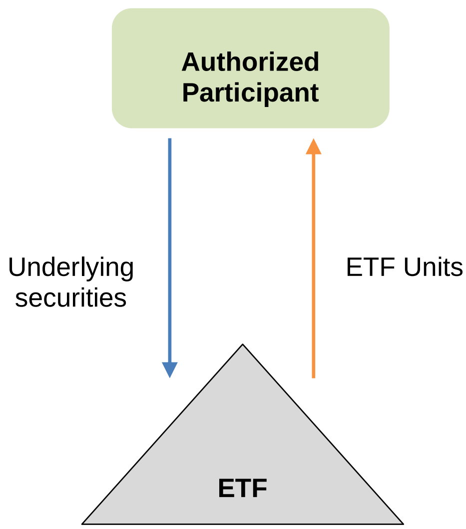
Appendix A

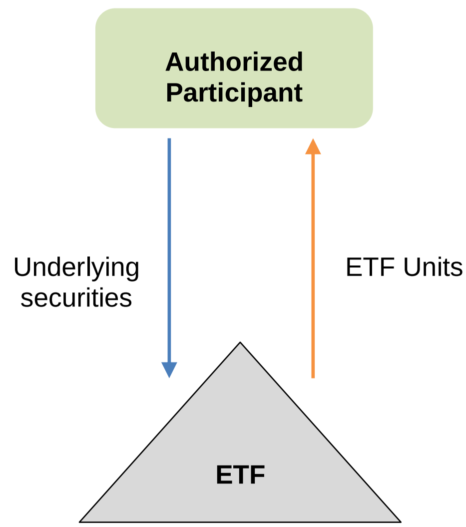
ETF SUBSCRIPTIONS AND REDEMPTIONS

- APs subscribe for ETF units with payment in-kind (i.e., with underlying securities) or in cash
- ETFs typically only redeem ETF units in-kind

In-kind Subscription (Issuance)



In-kind Redemption



Appendix B

The definition of CRIRP, and in particular paragraph (d) thereof, has undergone two sets of amendments that demonstrate an evolution as to how the SIFT rules take into account publicly-traded investment funds holding real estate or resource property.

When originally enacted in 2007, paragraph (d) of the CRIRP definition read as follows:

> (d) a share of the capital stock of a corporation, an income or a capital interest in a trust or an interest in a partnership, if more than 50% of the fair market value of the share or interest is derived directly or indirectly from one or any combination of properties described in paragraphs (a) to (c) [i.e., real property situated in Canada, Canadian resource property or timber resource property], or.

Thus, as originally enacted paragraph (d) contained no carveouts for issuers resident in Canada already bearing an appropriate level of entity-level tax. That changed in 2009, when the original paragraph (d) was replaced with a parenthetical carve-out:

> (d) a share of the capital stock of a corporation, an income or capital interest in a trust or an interest in a partnership (other than a taxable Canadian corporation, a SIFT trust or a SIFT partnership), if more than 50% of the fair market value of the share or interest is derived directly or indirectly from one or any combination of properties described in paragraphs (a) to (c), or".

In 2012, paragraph (d) was further amended:

> (d) a share of the capital stock of a corporation, an income or a capital interest in a trust or an interest in a partnership — other than a taxable Canadian corporation, a SIFT trust (determined without reference to subsection 122.1(2)), a SIFT partnership (determined without reference to subsection 197(8)) or a real estate investment trust (as defined in subsection 122.1(1)) — if more than 50% of the fair market value of the share or interest is derived directly or indirectly from one or any combination of properties described in paragraphs (a) to (c), or

After the decision in 2009 to exclude certain taxable entities from the ambit of paragraph (d), in 2012 the further step was taken to exclude certain non-taxable entities that Parliament had decided should not be subject to entity level SIFT tax – namely, real estate investment trusts (which are carved out of the definition of “SIFT trust” in subsection 122.1(1)), and SIFT trusts and partnerships that would be SIFTs except for the transitional relief provided for taxation years that end before 2011).

The above changes show a clear evolution to ensuring that the part of the CRIRP definition that refers to securities (as opposed to direct holdings of Canadian real or resource property) does not cause a publicly-traded Canadian resident trust to hold non-portfolio property – and thereby become a SIFT trust – by virtue of holding securities of publicly-traded issuers for which there are measures in place to ensure the “right” level of entity level tax (including none) applies to those underlying issuers.

Exhibit A

INVESTMENT COMPANY INSTITUTE

1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

By Electronic Delivery

December 9, 2022

Tom West
Deputy Assistant Secretary (Tax Policy)
US Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

William Paul
Acting Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

RE: Application of Inflation Reduction Act Tax Provisions to Certain Registered Funds

Dear Mr. West and Mr. Paul:

The Investment Company Institute[1] asks the Treasury Department and the Internal Revenue Service (IRS) to provide regulatory relief exempting certain registered investment funds from the tax provisions enacted by the Inflation Reduction Act of 2022 (the "Act"). Specifically, the new corporate minimum tax and the excise tax on the repurchase of corporate stock provide exceptions for all funds registered under the Investment Company Act of 1940 (the "1940 Act") that also are regulated investment companies (RICs) under the Internal Revenue Code. Our request, therefore, is limited to those 1940 Act registered funds that are not RICs for tax purposes (hereinafter referred to as "non-RIC funds").

An exception to these provisions for RICs is warranted because of their organizational structure and operation and the applicable securities laws and accounting standards. That rationale applies equally to these non-RIC funds. Absent such an exemption, application of the corporate minimum tax and the excise tax on stock repurchases to non-RIC funds will have adverse consequences on fund investors.

We thus ask the Treasury Department and the IRS to clarify that these non-RIC funds (1) are not "applicable corporations" for purposes of the corporate minimum tax, and (2) are not subject to the excise tax on corporate stock repurchases. The Act provides ample regulatory authority to the Treasury Department and the IRS to correct these oversights. We understand there are relatively few non-RIC funds, so this guidance would have very limited effect. The lack of such

[1] The Investment Company Institute (ICI) is the leading association representing regulated investment funds. ICI's mission is to strengthen the foundation of the asset management industry for the ultimate benefit of the long-term individual investor. Its members include mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and UCITS and similar funds offered to investors in Europe, Asia and other jurisdictions. Its members manage total assets of $27.8 trillion in the United States, serving more than 100 million investors, and an additional $7.4 trillion in assets outside the United States. ICI has offices in Washington, DC, Brussels, London, and Hong Kong and carries out its international work through ICI Global.

guidance, however, would impact significantly the investors in these funds, many of whom are retail investors saving for retirement and other needs.

Background

Registered Funds

Registered funds, which are quite different from traditional operating companies, are pooled vehicles that provide diversified investments to retail and institutional investors. These funds are governed by a board of directors or trustees and managed by third parties; they do not have employees of their own.

There are four main types of registered funds: mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs).[2] These funds provide different mechanisms, as discussed in the appendix, by which investors acquire and dispose of their interests in the funds.

All funds that register with the Securities and Exchange Commission (SEC) under the 1940 Act are highly regulated. The 1940 Act and the rules thereunder govern the structure and operations of investment companies through a combination of registration and disclosure requirements and restrictions on day-to-day operations. Among other things, the 1940 Act addresses capital structures, custody of assets, investment activities, and the duties of fund boards. The fund industry also is subject to the Investment Advisors Act of 1940, the Securities Exchange Act of 1934, and the Securities Act of 1933.

Taxation of RICs

To qualify as a RIC under Subchapter M of the Internal Revenue Code, a corporation must be registered under the 1940 Act and must satisfy certain income and asset tests.[3] These qualification tests include strict limits on a RIC's income and assets and apply in addition to any income and asset requirements under the 1940 Act.

One of the benefits of a RIC as an investment vehicle is that it pays little or no tax at the corporate level if it satisfies the Subchapter M qualification tests and certain distribution

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[2] For additional information about the types of funds and the industry overall, *see* 2022 Investment Company Fact Book, which can be found at: https://www.icifactbook.org/.

[3] Section 851. At least 90 percent of a RIC's gross income must be derived from certain sources, including dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stock, securities, or foreign currencies. In addition, at the close of each quarter of the RIC's taxable year, at least 50 percent of the value of the RIC's total net assets must consist of cash, cash items, government securities, securities of other funds, and investments in other securities that, with respect to any one issuer, represent neither more than 5 percent of the assets of the RIC nor more than 10 percent of the voting securities of the issuer. Further, no more than 25 percent of the RIC's assets may be invested in the securities of any one issuer (other than government securities or the securities of other RICs), the securities (other than the securities of other RICs) of two or more issuers that the RIC controls and that are engaged in similar trades or businesses, or the securities of one or more qualified publicly traded partnerships.

requirements under section 852. Because RICs can deduct from taxable income the dividends paid to investors,[4] all tax is paid at the investor level. Subchapter M, and the dividends paid deduction, effectively provide fund investors with tax treatment comparable to that of direct investors in securities. Various distribution requirements applicable to RICs ensure that essentially all of a RIC's taxable income and gains are distributed to investors during the calendar year in which these amounts are earned.[5]

Non-RIC Funds

Although most 1940 Act-registered funds are RICs for tax purposes, there are some funds that do not qualify under Subchapter M because their investments do not meet the qualification tests. Many of these funds are closed-end funds or ETFs that invest in master limited partnerships, exceeding the 25% limitation on investment in publicly traded partnerships.[6] Funds that are registered under the 1940 Act that are not RICs are not eligible to deduct the dividends paid to investors and are taxed instead under the general corporate tax rules.

New Corporate Minimum Tax

The Act imposes a new 15% minimum tax on the "adjusted financial statement income" (as defined under new section 56A) of certain large corporations. These corporations would pay the larger of the minimum tax or the regular tax. The minimum tax generally is applicable to corporations with over $1 billion in annual adjusted financial statement income for any three consecutive taxable years preceding the tax year. The new minimum tax is effective for taxable years beginning after December 31, 2022. An applicable corporation for this purpose specifically excludes RICs, real estate investment trusts (REITs), and S corporations.

The purpose of the corporate minimum tax is to ensure that corporations with significant book income do not avoid paying their fair share of tax. Although they are not the target of this provision, investment companies that are registered under the 1940 Act require an exemption to prevent their unrealized gains from being subject to the minimum tax.

The unique issue for 1940 Act-registered funds arises from the Generally Accepted Accounting Principles (GAAP) requirement to report investments on financial statements at fair market value rather than historical cost.[7] Unlike other corporations, the financial statements of all registered

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[4] The dividends paid deduction (DPD) is provided under section 561.

[5] Section 852(a) requires a RIC to distribute at least 90 percent of its income and gains for its fiscal year, generating a DPD for those amounts, to qualify as a RIC under Subchapter M. Any amount retained by the RIC above the 90 percent will be subject to a RIC-level tax. RICs also are subject to a 4 percent excise tax under section 4982 if they do not distribute annually 98 percent of their ordinary income (measured on a calendar year basis) and 98.2 percent of their capital gains (measured through October 31), plus any amounts not distributed in the prior calendar year. The net effect of these requirements is that RICs generally distribute substantially all their income and gains each year.

[6] For a more detailed description of closed-end funds and ETFs, *see* Appendix.

[7] *See e.g.,* Financial Accounting Standards Board, *Accounting Standards Codification*, Topic 946-45-6.

funds (whether or not they qualify as RICs) include unrealized gains on marketable securities as income. Taxing unrealized gains clearly was not the provision's purpose. While the exemption for RICs prevents them from this potential and unintended tax, the exemption does not apply to those 1940 Act funds that cannot qualify as RICs.

Section 59(k) defines "applicable corporation" for purposes of the alternative minimum tax. Section 59(k)(1) specifically excludes RICs from this definition. Non-RIC funds, however, still could be subject to the minimum tax if they otherwise satisfy the $1 billion threshold because their adjusted financial statement income could be higher due to the unrealized gains recognized for book purposes.

Section 59(k)(3) provides general regulatory authority to the Secretary to provide regulations and other guidance for the purposes of carrying out the corporate minimum tax provisions. We ask the Treasury Department and the IRS to exercise this authority, by exempting non-RIC funds from the definition of "applicable corporation," and thereby preventing unintended consequences that would harm fund investors.

New Excise Tax on Stock Buybacks

Section 10201 of the Act added to the Internal Revenue Code new section 4501, Repurchase of Corporate Stock. This provision imposes on each "covered corporation" a tax equal to one percent of the fair market value of any stock of the corporation that is repurchased by the corporation during the taxable year, if the total value of the stock repurchased exceeds $1,000,000. A "covered corporation" generally includes any corporation the stock of which is traded on an established securities market (within the meaning of section 7704(b)(1)). New section 4501(e)(5) provides an exception to the excise tax for repurchases by a RIC (as defined in section 851) or a REIT. This provision is effective for transactions occurring after December 31, 2022.

The original sponsors of this legislation have stated that its purpose is to tax corporations that use savings from the 2017 corporate tax rate cut to buy back shares of their own stock, further enriching executives and wealthy shareholders, rather than investing in workers or communities. Investment companies, including non-RIC funds, are not operating companies and do not have employees. Although non-RIC funds may have benefited from the corporate rate tax cuts, the sole purpose of these investment vehicles is to provide a return to investors.

Non-RIC funds, like RICs, redeem and repurchase their shares in routine transactions. Redemption of shares by authorized participants are a crucial factor in the proper functioning of ETFs and help maintain parity between the trading price of an ETF on the secondary market and the net asset value (NAV) of the fund. Closed-end funds often repurchase shares for this same reason. Also, many closed-end fund repurchases of preferred shares are scheduled in advance; imposing an excise tax on these transactions fundamentally would change the shareholders' investment. These funds are not "abusing" the tax laws; rather, they are engaged in routine redemption and repurchase activities. The excise tax ultimately would be borne by the funds' shareholders, many of whom are moderate-income investors saving for retirement, education, or other important needs.

Like RICs, non-RIC funds should not be subject to the excise tax on stock buybacks. We thus ask the Treasury Department and the IRS to issue guidance providing that funds registered under the 1940 Act that are not RICs similarly are exempt from this provision. We note that Section 4501(f) provides authority to the Secretary to provide regulations and other guidance as necessary and appropriate to carry out this provision, including, among other things, guidance needed to address special classes of stock and preferred stock. We believe that this provision gives the government the authority to grant directed relief to non-RIC funds.

* * *

We appreciate your prompt attention to our request. We will contact your offices to discuss the matter further, but please do not hesitate to reach out to me (202/371-5432 or kgibian@ici.org) if you have additional questions or concerns.

Sincerely,

Karen Lau Gibian
Associate General Counsel, Tax Law

cc: Krishna Vallabhaneni
Brett York
Michael Novey
Robert Wellen
Helen Hubbard

APPENDIX

Closed-End Funds

A closed-end fund is a type of investment company the shares of which are listed on a stock exchange or traded in the over-the-counter market. The assets of a closed-end fund are professionally managed in accordance with the fund's investment objectives and policies and may be invested in equities, bonds, and other securities. The market price of a closed-end fund share fluctuates like that of other publicly traded securities and is determined by supply and demand in the marketplace.

A closed-end fund is created by issuing a fixed number of common shares to investors during an initial public offering. Subsequent issuance of common shares can occur through secondary or follow-on offerings, at-the-market offerings, rights offerings, or dividend reinvestments. Closed-end funds also are permitted to issue one class of preferred shares in addition to common shares.

Holders of preferred shares are paid dividends but do not participate in the gains and losses on the fund's investments. Issuing preferred shares allows a closed-end fund to raise additional capital, which it can use to purchase more securities for its portfolio. Once issued, shares of a closed-end fund generally are bought and sold by investors in the open market and are not purchased or redeemed directly by the fund, although some closed-end funds may adopt stock repurchase programs or periodically tender for shares.

Because a closed-end fund does not need to maintain cash reserves or sell securities to meet redemptions, the fund has the flexibility to invest in less-liquid portfolio securities. For example, a closed-end fund may invest in securities of very small companies, municipal bonds that are not widely traded, or securities traded in countries that do not have fully developed securities markets.

Exchange Traded Funds

An ETF is similar to a mutual fund in that it offers investors a proportionate share in a pool of stocks, bonds, and other assets such as derivatives or bank loans. Like a mutual fund, an ETF is required to post the mark-to-market NAV of its portfolio at the end of each trading day and must conform to the main investor protection mechanisms of the 1940 Act, including limitations on leverage, daily valuation and liquidity requirements, prohibitions on transactions with affiliates, and rigorous disclosure obligations. Also, like mutual funds, creations and redemptions of ETF shares are aggregated and executed just once per day at NAV.

Despite these similarities, key features differentiate ETFs from mutual funds. One major difference is that retail investors buy and sell ETF shares on the secondary market through a broker-dealer, much as they would any other type of stock. In contrast, mutual fund shares are not listed on stock exchanges but are purchased and sold through a variety of distribution channels, including through investment professionals or directly from a fund company or discount broker.

Pricing also differs between mutual funds and ETFs. Mutual funds are "forward priced," meaning that, although investors can place orders to buy or sell mutual fund shares throughout the day, all orders placed during the day will receive the same price – the NAV – the next time it is computed. Most mutual funds calculate their NAV as of 4:00 p.m. eastern time because that is when US stock exchanges typically close. In contrast, the market price of an ETF share is continuously determined on a stock exchange. Consequently, the price at which investors buy and sell ETF shares on the secondary market may not necessarily equal the NAV of the portfolio of securities in the ETF. Two investors selling the same ETF shares at different times on the same day may receive different prices for their shares, both of which may differ from the ETF's NAV, which, like a mutual fund, generally is calculated as of 4:00 p.m. eastern time.

Authorized Participants (APs) are critical to an ETF's efficient operation. First, APs are the only parties (other than the ETF itself) involved in the creation or redemption of ETF shares. APs contribute securities to the ETF, in the form of "creation baskets," for a fixed number of ETF shares that the AP then sells on the exchange. APs also can redeem the same number of ETF shares and receive an equal-valued basket of the ETF's portfolio securities and/or cash.

Second, APs, along with other market participants such as market makers and proprietary trading firms, perform the critical arbitrage function that benefits all investors, including those holding ETF shares in retirement accounts. Specifically, these market participants (which can include APs) buy ETF shares on the secondary market when the ETF's market price falls below its NAV and then redeem the ETF shares through APs. These redemptions are necessary to ensure that retail investors selling their ETF shares in the secondary market receive a price close to the NAV when those shares are sold. This arbitrage function, which requires the repurchase of shares by the ETF, is a critical and essential element of the commercial success of ETFs. It allows the markets to ensure adequate liquidity and transparent price discovery on a continuous basis.

Exhibit A

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By Electronic Delivery

February 21, 2023

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Robert Wellen
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Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

RE: Non-RIC Registered Investment Companies Should be Exempted from Two Provisions of the Inflation Reduction Act

Dear Mr. Vallabhaneni and Mr. Wellen:

This letter follows up on the recent discussion between the Investment Company Institute[1] and representatives from the Treasury Department and the Internal Revenue Service (IRS) regarding (i) the stock repurchase excise tax and (ii) corporate alternative minimum tax provisions of the Inflation Reduction Act of 2022 (the IRA). Specifically, we are seeking exceptions from these provisions for investment companies that are registered under the Investment Company Act of 1940[2] but that are not regulated investment companies (RICs) for tax purposes[3] (hereinafter referred to as "non-RIC funds").

Importantly, the IRA expressly excepts RICs from these two provisions. Congress recognized that the policy concerns leading to their enactment do not apply to RICs, given their organizational structure and operation, and the applicable securities laws and accounting standards.

The Congressional rationale for excepting RICs, as explained during our meeting and below, applies equally to non-RIC funds. Absent the exemption that we request from these two

[1] The Investment Company Institute (ICI) is the leading association representing regulated investment funds. ICI's mission is to strengthen the foundation of the asset management industry for the ultimate benefit of the long-term individual investor. Its members include mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and UCITS and similar funds offered to investors in Europe, Asia and other jurisdictions. Its members manage total assets of $28.3 trillion in the United States, serving more than 100 million investors, and an additional $7.4 trillion in assets outside the United States. ICI has offices in Washington, DC, Brussels, London, and Hong Kong and carries out its international work through ICI Global.

[2] 15 United States Code (U.S.C.) §§ 80a-1 *et seq*.

[3] 26 U.S.C. §§ 851 *et seq*.

provisions, retail investors in non-RIC funds—who typically are saving for retirement and other important purposes—will be impacted negatively.

Most immediately, we request expedited attention to the application to non-RICs of the excise tax on stock buybacks. The stock buyback tax, as we discussed, applies only to non-RIC funds that are structured as exchange-traded funds (ETFs) or exchange-traded closed-end funds. As discussed during our meeting, and in our prior submission,[4] both types of funds trade (in whole or in part) on the secondary market. Because these funds are required to calculate regularly the net asset value (NAV) of their shares, investors know when these funds trade at a premium or a discount to the value of their investments. To ensure the proper functioning of the ETF structure, ETFs may redeem shares that authorized participants (APs) tender. Closed-end funds may buy back their shares to reduce the trading discount. In each case, as further described below, these redemptions and buy backs provide a direct benefit to their shareholders.

Expedited guidance for these funds is needed to address two situations. First, the closed-end funds with longstanding tender programs in place will be required to repurchase shares this year. Second, ETFs, which are structured to allow frequent (often daily) stock issuances and repurchases (through creations and redemptions) to ensure the proper functioning of their arbitrage mechanism, will need to determine when and how to calculate the net impact of the offsetting transactions. Prompt guidance excepting these non-RIC funds from the excise tax would save them from applying the rules now and then later unwinding the consequences for their shareholders who incur the tax.

The Requests for Additional Information

This letter addresses four requests for additional information that were raised during our recent meeting. We appreciate the time that you spent with us and this opportunity to respond. The requests relate to (1) the number of non-RIC funds; (2) the relationship between APs and ETFs; (3) our view regarding why non-RIC funds do not raise the policy concerns that the tax provisions are intended to address; and (4) a drafting proposal for excepting these funds. We would be pleased to follow up at your convenience regarding these responses.

I. Number of Non-RIC Funds

ICI understands that the number of non-RIC funds impacted by the excise tax on stock repurchases and the corporate alternative minimum tax, as we discussed in our recent meeting, is relatively small. Almost all funds that are registered as investment companies under the 1940 Act are RICs for tax purposes because the benefits to investors of RIC qualification are substantial. A few registered investment companies, however, are unable to satisfy those requirements and thus are taxable as regular corporations.

Most of these non-RIC funds invest in energy master limited partnerships (MLPs). The only comprehensive information that we have on these funds comes from a list of MLP funds on the

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[4] *See* ICI Letter from Karen Gibian to Tom West and William Paul, dated December 9, 2022.

Energy Infrastructure Council's website.[5] Again, we believe that the number of non-RIC funds remains quite small.

II. The Relationship between Authorized Participants and an ETF

Redemptions by APs, as we discussed in our prior letter and our recent meeting, are integral to the proper functioning of ETFs and the value proposition for individual investors who buy and sell ETF shares only on the stock exchange. The attached document provides a detailed explanation of the role played by the AP.

To summarize, the creation/redemption role performed by APs allows the number of outstanding ETF shares to expand or contract based on demand. By facilitating adequate liquidity and transparent price discovery on a continuous basis, AP activity generally keeps ETF shares from trading at a significant discount to net asset value (NAV). This role that APs play in preserving shareholder value, therefore, is essential to the commercial success of ETFs. Also, it is important to note that the APs, not the ETFs, initiate the redemption requests, as set forth under the 1940 Act.

III. Policy Concerns

The policy concerns at which the excise tax on stock repurchases and the corporate alternative minimum tax are aimed, as we discussed during the meeting, are not raised by non-RIC funds. Our views are explained in greater detail below.

> *The tax on stock buybacks deters corporations from stock repurchases intended to provide exit liquidity for executives.*

Investment companies that are registered under the 1940 Act do not engage in stock repurchases to increase executive compensation. Not only do these funds generally not have employees, but the redemptions in open-end funds (including ETFs), as set forth under the 1940 Act, are initiated by the shareholders. The closed-end fund structure is different, as repurchases can be initiated by the fund, but the reason for such repurchases is not to benefit executives.

Non-RIC funds, like the vast majority of RICs, do not have employees. Stock repurchases and redemptions by these funds are intended to benefit the investors that hold shares in the ETFs or closed-end funds.

Further, section 22(g) of the 1940 Act restricts an open-end fund from issuing shares for services. We do not know of any advisers or funds, including closed-end funds, that pay employees in fund shares, though some employee compensation may be based on the performance of a fund.

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[5] The list is available at: https://eic.energy/current-mlps-and-mlp-funds/. Only those funds listed as "C corps" are impacted by the Inflation Reduction Act provisions. Many of the funds listed are open-end funds and therefore not subject to the excise tax on stock repurchases, as they are not traded on an exchange. These open-end funds, however, may be subject to the corporate alternative minimum tax. We note that the list (dated as of December 12, 2022) is not current, as a significant number of these funds have since liquidated.

In fact, we note a significant countervailing incentive: share repurchases reduce a fund's assets under management and the advisory fee paid to the adviser. Instead, as explained above and in the attachment, share repurchases are executed to increase shareholder return.

Given the structure and organization of non-RIC funds and relevant securities laws, these funds do not raise the executive compensation policy concern that led in part to the enactment of the excise tax on stock repurchases.

The tax on stock buybacks deters diversion of corporate resources from productive to unproductive uses.

Another policy concern underlying the new tax on stock repurchases, we understand, is that corporations are using resources to repurchase shares rather than investing them in workers, innovation, or other productive uses. These non-RIC funds, like RICs, are not operating companies. The cash used to fund stock repurchases or redemptions is providing better investment returns for the funds' remaining investors (who may be saving for retirement or other needs)—which is a very productive use indeed.

The tax on stock buybacks deters corporations from taking on unproductive debt.

A third policy concern supporting the excise tax on stock repurchases, we understand, is that corporations were taking on "unproductive debt" to finance these stock buybacks. Investment companies, however, are largely restricted by the 1940 Act from taking on debt. Moreover, debt that is taken on by funds is designed to increase leverage, within prescribed limits, and thereby enhance the investment returns for the fund's investors. Because these funds typically sell portfolio assets to meet redemption needs, the provision's rationale is inapplicable.

The 1940 Act places strict limits on the amount of debt that registered investment companies can incur. The combination of the rules regarding capital structure and derivatives/other instruments restricts a fund's ability to attain leverage. Section 18 of the 1940 Act imposes limits on a fund's ability to issue "senior securities," to ensure that funds can pay back their obligations. In general, a senior security is any debt that takes priority over the fund's shares. The SEC historically has interpreted the definition of senior security broadly; the limitations thus cover borrowings, issuances of preferred stock, and investments in derivatives.

An open-end fund (including ETFs) generally may borrow only from a bank. The fund must have 3:1 asset coverage[6] for that borrowing (e.g., a fund with $100 in assets can borrow $50, because after the borrowing, the fund would have $150 in assets covering $50 in borrowings).[7] A closed-end fund may borrow from any entities (including non-banks) if it has 3:1 asset

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[6] Section 18(h) of the 1940 Act defines "asset coverage."

[7] Section 18(f)(1) of the 1940 Act.

coverage for the borrowing.[8] In addition, it may issue preferred stock if it has 2:1 asset coverage.[9]

In addition to the limitations on capital structure, the SEC will not treat certain types of derivatives and other investments (e.g., reverse repurchase agreements and similar financings) that look like senior securities as senior securities under Section 18, if the fund investing in them adheres to certain conditions in Rule 18f-4 under the 1940 Act. For heavy users of derivatives, this includes a requirement that the fund have a derivatives risk management program overseen by a derivatives risk manager; these funds also must comply with outer bound limits on fund leverage based on value-at-risk.

> *The purpose of the tax on stock buybacks and the corporate alternative minimum tax is to claw back benefits of the 2017 tax cuts meant to go to productive uses.*

Finally, we understand that a reason for enacting the tax on stock repurchases and the corporate alternative minimum tax was to claw back benefits of the 2017 tax cuts that were used to finance stock buybacks, rather than investments in workers or other productive uses. As taxable corporations, these non-RIC funds did receive a rate cut in 2017. But, as explained above, non-RIC funds do not have employees or other "productive" uses for their assets. Moreover, as explained above, share repurchases by ETFs and closed-end funds are an integral mechanism needed to enhance investment returns for investors in the funds. Any savings from corporate rate cuts directly benefits these investors.

IV. Recommended Language

A straightforward exemption for non-RIC funds without specifically referencing the 1940 Act[10] could provide an exception for "corporations described in section 851(a)(1)." Section 851(a) defines the term "regulated investment company," which is any domestic corporation that, at all times during the taxable year, is (A) registered under the 1940 Act, or (B) has elected under the 1940 Act to be treated as a business development company.[11] Reference to section 851(a)(1) thus would include all investment companies that are registered under the 1940 Act even if they do not satisfy the other requirements in section 851.

Alternatively, the IRS could provide an exception for "corporations described in section 851(a) without regard to section 851(b)." Section 851(b) specifies the income and asset diversification requirements that a fund must satisfy for any taxable year in order to qualify as a RIC. The non-

[8] Section 18(a)(1) of the 1940 Act.

[9] Section 18(a)(2) of the 1940 Act.

[10] If a broad exception for non-RIC funds is not provided, then at the very least we request a grandfathering clause for preferred stock redemption programs for closed-end funds.

[11] Section 851(a)(2) refers to a common trust fund or similar fund excluded by section 3(c)(3) of the 1940 Act from the definition of "investment company" and that is not included in the definition of "common trust fund" by section 584(a). We do not know of any investment companies that fall under this category.

RIC funds for which we are seeking an exemption satisfy section 851(a) but do not satisfy section 851(b). This language also would provide the exception we are seeking.

* * *

We appreciate your consideration of our request, and we hope this additional information is helpful. Please do not hesitate to contact Keith Lawson (202-326-5832 or lawson@ici.org) or Karen Gibian (202-371-5432 or kgibian@ici.org) if you have any further questions.

Sincerely,

Keith Lawson
Deputy General Counsel, Tax Law

Karen Lau Gibian
Associate General Counsel, Tax Law

Attachment

cc: Brett York
Colin Campbell
Helen Hubbard
Lisa Fuller

ATTACHMENT

The Relationship Between Authorized Participants and Exchange Traded Funds

Redemptions by APs, as we discussed in our prior letter and our recent meeting, are integral to the proper functioning of ETFs. An AP typically is a market maker or large institutional investor with an ETF trading desk that has entered into a legal contract with the ETF to create and redeem shares of the fund. The agreement provides the terms for settling creation and redemption transactions. In addition, APs are U.S.-registered self-clearing broker-dealers that can process all required trade submission, clearance, and settlement transactions on their own behalf and for their own account, as well as full participating members of the NSCC and DTC. APs do not receive compensation from an ETF or its sponsor and have no legal obligation to create or redeem the ETF's shares. Indeed, APs pay fees for any creation or redemption orders submitted to the fund's distributor.

Generally, there is a nominal flat fee for a creation or redemption order of any size. For baskets that include a cash component, the fund may charge an additional variable asset-based fee to cover transaction costs incurred by the ETF to purchase or sell securities from the ETF's portfolio. APs derive their compensation from commissions and fees paid by clients for creating and redeeming ETF shares on their behalf and from any profits earned while engaging in arbitrage between an ETF's NAV and its market price.

The creation/redemption mechanism in the ETF structure allows the number of shares outstanding in an ETF to expand or contract based on demand. When ETF shares are created or redeemed, this is categorized as primary market activity. Like mutual funds, primary market activity is aggregated and executed just once per day at NAV. ETF shares are created when an AP submits an order for one or more "creation units." A creation unit consists of a specified number of ETF shares that generally range in size from 25,000 to 200,000 shares. The ETF shares are delivered to the AP when the specified creation basket is transferred to the ETF. The ETF may permit or require an AP to substitute cash for some or all of the assets in the creation basket, particularly when an instrument in the creation basket is difficult to obtain or transfer or may not be held by certain types of investors. An AP also may be charged a cash adjustment and/or a transaction fee to offset any transaction expenses incurred by the fund. The value of the creation basket and any cash adjustment equals the value of the creation unit based on the ETF's NAV at the end of the day on which the transaction was initiated. The AP can either keep the ETF shares that make up the creation unit or sell all or part of them to its clients or to other investors on a stock exchange.

The redemption process is simply the reverse. A creation unit is redeemed when an AP acquires (through purchases or exchanges, principal transactions, or private transactions) the number of shares specified in the ETF's creation unit and returns the creation unit to the ETF. In return, the AP receives the daily redemption basket of securities, cash, or other assets. The total value of the redemption basket is equivalent to the value of the creation unit based on the ETF's NAV at the end of the day on which the transaction was initiated.

The price of an ETF share on a stock exchange is influenced by the forces of supply and demand. Though imbalances in supply and demand can cause the price of an ETF share to deviate from its underlying value, substantial deviations tend to be short-lived for many ETFs. Two primary features of an ETF's structure help promote trading of its shares at a price that approximates the ETF's underlying value: portfolio transparency and the ability for APs to create or redeem ETF shares at NAV at the end of each trading day. Transparency of an ETF's holdings—either through full disclosure of the portfolio or through established relationships of the components of the ETF's portfolio with published indexes, financial or macroeconomic variables, or other indicators—enables investors to observe and attempt to profit from discrepancies between the ETF's share price and its underlying value during the trading day. ETFs may contract with third parties (typically market data vendors) to calculate and publish a real-time estimate of an ETF's underlying value. This calculation, often called the intraday indicative value (IIV), is based on the prior day's holdings and is disseminated at regular intervals during the trading day (typically every 15 seconds). APs, market makers, and other institutional investors also can make this assessment in real time using their own computer programs and proprietary data feeds.

When there are discrepancies between an ETF's share price and the value of its underlying securities, trading can more closely align the ETF's price and its underlying value. For example, if an ETF is trading at a discount to its underlying value, investors may buy ETF shares and/or sell the underlying securities. This change in demand for the ETF shares and the underlying securities should alter their respective prices and narrow the gap between the ETF share price and its underlying value. If the ETF is trading at a premium to its NAV, investors may choose to sell ETF shares or, alternatively, buy the underlying securities. These actions should reduce the ETF share price or raise the price of the underlying securities, bringing the prices of the ETF and its underlying securities closer together.

This type of trading, often in conjunction with a corresponding hedge, is common among (but not limited to) market makers maintaining a two-sided market in ETFs. The ability of APs to create or redeem ETF shares at the end of each trading day also helps an ETF trade at market prices that approximate the underlying market value of its portfolio. When a deviation between an ETF's market price and its NAV occurs, APs may create or redeem creation units in an effort to capture a profit.

For example, when an ETF is trading at a premium, APs may find it profitable to sell short the ETF during the day while simultaneously buying the underlying securities. APs then deliver the creation basket of securities and/or cash to the ETF in exchange for ETF shares that they use to cover their short sales. When an ETF is trading at a discount, APs may find it profitable to buy the ETF shares and sell short the underlying securities. APs then return the ETF shares to the fund in exchange for the redemption basket of securities and/or cash, which they use to cover their short positions. These actions by APs, commonly described as arbitrage opportunities, help keep the market-determined price of an ETF's shares close to its underlying value.

Prior to 2019, ETF issuers had to get individual exemptive relief from the Securities and Exchange Commission (SEC) to, among other things, redeem only in large creation unit sizes (i.e., not in individual shares). The SEC has since adopted Rule 6c-11 under the 1940 Act, which codifies the exemptive relief previously granted and allows ETFs to redeem in creation unit sizes if they comply with the conditions of the rule. This relief applies only to index-based ETFs and actively managed ETFs that fully disclose their portfolio holdings daily.