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

November 9, 2023

Delivered By Email : Trevor.McGowan@fin.gc.ca

Mr. Trevor McGowan
Associate Assistant Deputy Minister
Tax Policy Branch
Department of Finance Canada
90 Elgin Street
Ottawa, Ontario
K1A 0G5

Dear Mr. McGowan:

RE: Exemptions from the Application of the Mark-to-Market Rules for Investment Funds

The Investment Funds Institute of Canada ("**IFIC**") would like to endorse the March 15, 2022 submission to the Department of Finance (Canada) attached hereto made by the Canadian ETF Association ("**CETFA**") seeking an exemption from the mark-to-market rules in the *Income Tax Act* (Canada) ("**Tax Act**") for investment funds the units of which are (a) listed on a designated stock exchange in Canada, and (b) in continuous distribution.

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.

In addition, for some of the same reasons discussed in the CETFA submission, IFIC would like to request a two-year safe harbour from the mark-to-market rules for "unit trusts" (sometimes referred to as "pooled funds" as described below) for their first two years of existence. This exception would be similar to that already found in the Tax Act for segregated funds, which exempts segregated funds from being financial institutions in their first two years of existence as long as the cost of the insurer's seed does not exceed $5 million (Reg. 9000(c)).

Similar to a portion of the segregated fund marketplace, several of our members have "pooled funds" (which are generally structured as "unit trusts" for purposes of the Tax Act) that target institutional investors. Because of their market focus, these pooled funds are usually not formed nor expected to become "mutual fund trusts" for purposes of the Tax Act. Some of our members that are "financial institutions" that have pooled funds are disadvantaged vis-à-vis their segregated fund competitors because they may be subject to the "mark-to-market" regime in their first two years of existence when the pooled funds are launched with seed capital from the financial institutions. From a marketing perspective, it is also sometimes the case that the fund will be launched with just the seed capital investment in order to establish a track record. In such cases, unlike segregated funds, pooled funds launched by financial institutions will often be subject to the "mark-to-market" regime, which, as stated in the CETFA submission, will disproportionately impact the taxable investors that have to make sense of multiple taxation-year end distributions with differing tax characterizations, and multiple reporting slips. A two-year safe

harbour from the mark-to-market regime will also benefit funds that intend to be "mutual fund trusts", but have either not been able to reach their dispersal requirements in the first two years of existence, or are having issues continually meeting them.

We thank the Department 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.

Please feel free to contact me by email at jbaillargeon@ifici.ca or, by phone 416-309-2323.

Yours sincerely,

THE INVESTMENT FUNDS INSTITUTE OF CANADA

By: Josée Baillargeon
Senior Policy Advisor, Taxation

March 15, 2022

Delivered By Email: trevor.mcgowan@canada.ca

Mr. Trevor McGowan
Director General
Tax Policy Division
Finance Canada
90 Elgin Street
Ottawa, ON K1A 0G5

Dear Mr. McGowan:

RE: Exemptions from the Application of the Mark-to-Market Rules for Investment Funds

I. Introduction

Most businesses utilize accrual accounting to determine their income for tax purposes, however, subsection 142.5(1) of the *Income Tax Act* (Canada) ("Tax Act") requires all entities captured by the definition of financial institutions to mark all mark-to-market property to market thus reporting all accrued gains and losses on income account whether or not the property is disposed of (the "mark-to-market rules").

The mark-to-market rules that were introduced in 1995 were intended to prevent financial institutions from being able to accrue gains until their disposition while recognizing accrued losses on securities that were being held on inventory account. They were not intended to negatively impact small investors simply because they chose to invest through a listed pooled vehicle. As a result, mutual fund trusts and mutual fund corporations were specifically excluded from the application of the mark-to-market rules.

As the Department of Finance (Canada) ("Finance") has previously heard from the investment fund industry with the expansion of the investment funds industry and the introduction of new market participants and products, the mutual fund trust definition is increasingly hard to meet within the first year of an investment trust's existence.[1]

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[1] Below is an excerpt from a September 19, 2006 letter to Finance from the Investment Counsel Association of Canada ("ICAC"):

> Reduce the threshold of investors necessary for a unit trust to qualify as a mutual fund trust
>
> Most commercial unit trusts are established to make investments in portfolio securities. "Mutual fund trusts" are unit trusts that meet certain conditions in the ITA relating to the public offering of their securities and minimum distribution of securities to the public, generally requiring at least 150 investors. The 150 investor requirement be relevant in the context of a "retail" fund that is marketed to smaller investors. It's less relevant in the context of a unit trust established to pool investments from a small number of large investors (such as registered pension plans or other pooling vehicles) many of which have multiple investors. "Mutual fund trust" status affords a unit trust a number of tax advantages including exemption from alternative minimum tax and the availability of the capital gains refund mechanism. It is respectfully submitted that mutual fund trust status should be made available to unit trusts with a smaller number of large investors subject to appropriate anti-avoidance rules (for example to deal with non-resident investors). As an alternative to the current 150 investor requirement, which should be retained for "retail" funds, it is submitted that a unit trust with 20 investors having a minimum investment of $1 million also be sufficient.

While we understand that Finance is considering submissions from other industry associations on modernizing the mutual fund trust definition, we also know that such consultations involve a more holistic consideration of the definition.

Our submission addresses a discrete and urgent request, since the application of the mark-to-market rules to listed funds that do not meet the mutual fund trust definition subjects those funds to very costly and complicated compliance requirements that disproportionately impact investors who are not financial institutions, and create a significant disadvantage for new market participants and innovations in the exchange traded fund ("ETF") market that our organization represents.

II. Background

The mark-to-market rules apply to financial institutions, which are defined in the mark-to-market rules as follows:

"financial institution" at any time means

(a) a corporation that is, at that time,

(i) a corporation referred to in any of paragraphs (a) to (e.1) of the definition "restricted financial institution " in subsection 248(1) ,

(ii) an investment dealer, or

(iii) a corporation controlled by one or more persons or partnerships each of which is a financial institution at that time, other than a corporation the control of which was acquired by reason of the default of a debtor where it is reasonable to consider that control is being retained solely for the purpose of minimizing any losses in respect of the debtor's default, and

(b) a trust or partnership more than 50% of the fair market value of all interests in which are held at that time by one or more financial institutions, but does not include

(c) a corporation that is, at that time,

(i) an investment corporation ,

(ii) a mortgage investment corporation ,

(iii) a mutual fund corporation , or

(iv) a deposit insurance corporation (as defined in subsection 137.1(5)),

(d) a trust that is a mutual fund trust at that time, nor

(e) a prescribed person or partnership;

<u>*Legislation History*</u>

The mark-to-market rules, and the definition of financial institution therein were added by 1995, c.21, *An Act to amend the Income Tax Act, the Income Tax Application Rules and related Act* C-70 at ss.58, applicable to taxation years ending after February 22, 1994.

<u>*Budget Statements*</u>

The Fall 1994 Budget statements provide insight into Parliament's intention with regards to the mark-to-market rules. It is clear from both the Budget Plan and Budget Brief that the intention behind the mark-to-market rules was to prevent financial institutions from being able to accrue gains until disposition while recognizing accrued losses on securities which were being held on inventory. Thus the mark-to-market rules require consistent income treatment across the securities held by these financial institutions on the basis that these kinds of securities are integral to their business.

Specifically, the Budget Plan references "Securities Transaction by Financial Institutions" providing at page 44 that:

> The budget proposes several changes to the tax treatment of securities held by financial institutions to clarify the tax treatment of these securities and to ensure that the income from these securities is measured appropriately.

Further, the Budget Brief states at page 17 that the proposed new measures were intended to "ensure that the income of financial institutions is measured appropriately for tax purposes."

Parliamentary Discussions
Parliamentary discussions around the amendment further support this conclusion. When Bill C-70 was being read for the second time, the Parliamentary Secretary to the Minister of Finance stated as follows with regards to the introduction of the mark-to-market rules:

> [W]e now require financial institutions to report profits and losses on securities held in the ordinary course of business, on income rather than capital on a market to market basis.

III. Submission

Since their inception, the mark-to-market rules have excluded "mutual fund trusts" and "mutual fund corporations" as those terms are defined for purposes of the Tax Act. At the time of the mark-to-market rules introduction, each of those products would have represented the bulk of the investment funds market. Since that time, the investment funds market has expanded considerably to include other products such as ETFs and other listed funds that would not have been contemplated by the original drafters of the mark-to-market rules.

The concern with ETFs failing to meet mutual fund trust status and the application of the mark-to-market rules is particularly acute in the start-up phase of an ETF, since financial institutions play such a key role establishing and sustaining the market for ETF units.

As noted in the risk factors for the prospectuses for many ETFs, if an ETF does not qualify as a mutual fund trust and more than 50% (based on fair market value) of the units of the ETF are held by one or more unitholders that are considered "financial institutions" for purposes of the mark-to-market rules in the Tax Act, then the ETF will be treated as a financial institution under those rules. As a result, the ETF will be required to recognize income for each taxation year during which it is a deemed financial institution on the full amount of gains and losses accruing on certain types of securities that it holds, and also will be subject to special rules with respect to income inclusion on these securities. Any income arising from such treatment will be included in the amounts distributed to unitholders. If more than 50% of the units of the ETF cease to be held by financial institutions, the tax year of the ETF will be deemed to end immediately before that time and gains or losses accrued before that time will be deemed realized by the ETF and will be distributed to unitholders. It is often difficult or impractical to monitor the specific designated broker/authorized participants' percentages on a real time basis. If the Declaration of Trust that governs the ETF does not provide for an automatic distribution at a deemed taxation year-end and that distribution is

not automatically consolidated into additional units so that the unitholder has the same number of units before and after the deemed distribution, then the application of the mark-to-market rules in these circumstances will result in an error in the net asset value ("NAV") of the units of the ETF. Initially, following the creation of an ETF, financial institutions (e.g., the designated broker that entered into a designated broker agreement with the applicable ETF) will hold all the outstanding units of the relevant ETF. Since the designated brokers and other market participants beneficially own the ETF units, at least during the initial start-up phase of an ETF, there may be several deemed year-ends as a result of the application of the mark-to-market rules as financial institutions go above and below the 50% fair market value threshold. We understand that the difficulty in ascertaining such changes in status for an ETF given the manner in which it is sold, and the potential for a large number of such deemed year-end events was previously discussed with Finance as part of the loss restriction event rule submissions.

The investors that are most impacted by the application of the mark-to-market rules in these circumstances are not the financial institutions that trigger the rules, as they are already subject to the mark-to-market taxation, but the rest of the investors in the ETF, particularly the taxable investors that have to make sense of multiple taxation year-end distributions with differing tax characterizations, and multiple reporting slips. These are often the same smaller investors that Finance choose to give protection to when they excluded mutual fund trusts and mutual fund corporations at the inception of the rules. Attached as an Appendix to this submission is an example of the impact of the rules to such investors prepared by one of our industry members.

IV. Proposed Amendment

CETFA proposes that the definition of a "financial institution" be amended to exclude any trust if, in that taxation year, units of the trust are:

a) listed on a designated stock exchange in Canada, and
b) in continuous distribution.

We submit that while the above proposed amendment to the mark-to-market rules relieves the large compliance costs associated with failing to meet mutual fund trust status for certain listed funds, it would not lead to a significant reduction in the tax base since the imposition of the rules largely impacts the timing and not the character of distributions.

If you have any questions or comments, please contact me by email at patdunwoody@cetfa.ca or by phone at 416-559-4234.

Yours sincerely,

Pat Dunwoody
Executive Director
Canadian ETF Association