Mr Brian Ernewein
General Director
Finance Canada
TP – Sr. Assistant Deputy Minister's Office
140 O'Connor St
Ottawa, Ontario K1A 0G5
Canada

May 7, 2010

Dear Mr. Ernewein:

Re: 2010 Budget Proposals Relating to Foreign Investment Entities ("FIEs") and Non-Resident Trusts ("NRTs")

The Investment Counsel Association of Canada ("ICAC") is pleased to submit its comments on the 2010 Budget proposals relating to FIEs and NRTs.

As background, the Investment Counsel Association of Canada ("ICAC") represents investment management firms registered to do business in Canada as portfolio managers. Some of our member firms are dually registered as exempt market dealers or other registration categories, but generally 70% of their income must be derived from portfolio management activities in order to be members of the ICAC. Our 125 + members are from across Canada and comprise both large and small firms managing both institutional and private client portfolios. The ICAC was established in 1952 and its members manage in excess of $700B assets (excluding publicly offered mutual fund assets).

Our mission is to advocate the highest standards of unbiased portfolio management in the interest of the investors served by Members.

ICAC endorses the 2010 Budget proposal not to proceed with the FIE rules. It has been our position that the FIE rules were overly broad since every non-resident entity in which a taxpayer invests would have had to be examined in order to determine whether it was in fact an FIE and if the investor's interest was a participating interest (other than an exempt interest). We have all along regarded current section 94.1 of the *Income Tax Act* (Canada)("ITA") as being an appropriately targeted rule—in particular, that one of the main reasons for acquiring, holding or having the interest be to derive a benefit from portfolio investments in such a way that the taxes on the income, profits and gains therefrom be significantly less than the tax payable under Part I of the ITA if the investments were held directly by the investor.

We endorse the proposal that taxpayers who included amounts in income in prior years on the basis that the proposed FIE rules would be implemented will have the option of having those years reassessed or claiming a deduction for any excess inclusion in the current year. The latter is particularly important for our industry to avoid the need to amend returns for prior years which would require issuing thousands of corrected T3 reporting slips to investors. We note that the

transitional rule previously introduced to allow a deduction after the last false start was not well worded from a technical viewpoint. Finance will need to take into account (i) that taxpayers may already have claimed a deduction for amounts previously included in income, (ii) that the FIE rules may have been applied in some years, then not applied when introduction was deferred or became doubtful, then applied again, and (iii) amounts may have been included in income as either ordinary income or capital gains. There is also the additional complexity related to ACB adjustments that have been made. Issues arise about how these should be taken into account and when.

ICAC also endorses the 2010 Budget proposals relating to the modifications to the NRT Rules. However, we do have a number of technical comments on the proposed changes and a more general observation from a policy perspective.

From a policy perspective, the NRT rules generally try to distinguish between *bona fide* "commercial" trusts, to be treated as exempt foreign trusts, and other trusts where avoidance of Canadian tax is more likely to be of concern. We respectfully submit that the same distinction can be made at the investor level also. In particular, we submit that that a mutual fund corporation and a mutual fund trust, and its respective shareholders or unitholders, should be excluded from the definitions of "resident contributor" and "resident beneficiary".

From a technical perspective, we note that the definition of paragraph (h) of the definition of "exempt foreign trust" is to be revised to require that the following conditions be satisfied:

(a) Each beneficiary is entitled to both income and capital of the trust.

(b) Any transfer of an interest by a beneficiary results in a disposition for the purposes of the ITA and interests in the trust cannot cease to exist otherwise than as a consequence of a redemption or cancellation under which the beneficiary is entitled to receive the fair market value of the interest. This requirement may be problematic in the case of certain trusts which may mandate the redemption of a beneficiary's interest in the trust for other than fair market value if the beneficiary is not permitted to hold an interest by applicable (e.g., securities) law.

(c) The amount of income and capital payable to a beneficiary does not depend on the exercise of, or failure to exercise, discretion by any person. This requirement may be problematic where, for example, the trustee has the discretion to allocate expenses to different classes of interests. We understand that the administrative position of the Canada Revenue Agency is that the trustee may have the discretion to determine when to make distributions.

(d) Interests in the trust (i) are listed and regularly traded on a designated stock exchange, (ii) were issued by the trust for fair market value or (iii) where the trust has at least 150 investors, are available to the public in an open market. It is not obvious to us why the narrower concept of "designated" stock exchange is used rather than "recognized exchange".

(e) The terms of the trust cannot be varied without the consent of all of the beneficiaries or, in the case of a widely held trust, a majority of the beneficiaries. This requirement is problematic as most trust agreements for commercial trusts permit amendments

without consent where the amendment is of a non-material nature (e.g., to correct typos and make other changes that do not result in change in the value of the beneficiary's interest) or is necessary to comply with applicable law.

(f) The trust is not a personal trust.

It is not clear to us whether the foregoing conditions establish an exemption in addition to those in paragraph (h) of the definition of "exempt foreign trust" or are intended as a restatement of the conditions in paragraph (h).

We note that the exceptions for "registered pension plans" and other "qualifying pension entities" from the definition of "resident contributor" and "resident beneficiary" which were first announced in comfort letters in April 2008 are included in the Budget proposals and are expressed so as to encompass all entities exempt from tax under subsection 149(1) of the ITA. We note that the comfort letters contemplated that an RPP that is a "designated plan" or a plan with fewer than 10 members would not benefit from the exception. The 2010 Budget papers do not make such a distinction. We also note that the comfort letters contemplated that certain participants in certain pooling arrangements, and the arrangements themselves, would not be a "resident contributor" or a "resident beneficiary". We do not see any mention of pooling arrangements in the Budget papers in relation to the proposed exception from the definitions of "resident contributor" and "resident beneficiary".

As the stated intent is that the NRT rules not apply to *bona fide* commercial trusts, we suggest that some very clear additions be made to the definition of "exempt foreign trust". Our initial suggestion is that a trust that is a "Regulated Investment Company" for the purposes of sections 851(b) at 857(a) of the United States Internal Revenue Code of 1986 be added to that definition. Such entities were carved out of the proposed FIE rules under proposed paragraph 94.1(2)(n).

We have some concern about the coming into force of the proposals, given past experience. We respectfully submit that the proposals be effective for taxation years ending after Royal Assent to the enabling legislation. From an accounting perspective, the proposed rules cannot be reflected in financial statements until they are "substantively enacted."

Members of our Industry Regulation and Taxation Committee would be pleased to meet with you in Ottawa to further discuss our comments.

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President, ICAC

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Chair, ICAC Industry, Regulation & Tax Committee
Assistant Vice President, Legal, Mackenzie Investments