May 5, 2009 Meeting

Department of Finance Officials & ICAC

Investment Counsel Association of Canada

May 2009

Executive Summary

Organizational Profile

The Investment Counsel Association of Canada (ICAC) is the official voice of the country's investment management community. Established in 1952, the ICAC now represents more than 120 investment counsel firms and portfolio managers who collectively manage more than $700 billion of assets on behalf of more than one million institutional and private investors.

Purpose

The ICAC performs several roles. First it helps members stay abreast of, and comply with, regulatory requirements and provides educational and best practice seminars to encourage integrity, public responsibility and competence in the profession. Second, it communicates the collective views of members and their clients to securities regulators and other government agencies. Third, it seeks to increase public awareness of the benefits of investment counselling.

Members

Member firms of the ICAC can be found across Canada employing a range of investment styles and proprietary approaches to meet clients' needs, objectives and risk tolerances. No two firms are alike. Some are boutiques with assets under management of less than $100 million; others are large firms with assets under management of more than $25 billion. Member firms manage money for private individuals saving for retirement, pension funds, corporate endowments, foundations, mutual funds and corporations.

Key Issues for Discussion:

ICAC has for the past few years been working on 3 key issues which impact seniors and Canadians ability to save for retirement and to optimize their investments. In light of the recent market downturn, and significant loss in capital of most Canadians, these 3 issues have become increasingly critical.

- **150 Unit Holder Rule** – this threshold for trusts to qualify as Mutual Fund Trusts has the effect of unfairly subjecting some seniors and Canadians saving for retirement to less favourable tax treatment than other Canadians who invest in extremely similar pooled investment vehicles. During the last 18 months, many Canadians have withdrawn savings from funds which have resulted in an increasing number of funds dropping below the 150 unit threshold. The remaining pension plans and RRSPs in the fund are immediately subject to tax even though these savings are tax exempt. This is inconsistent with the general principles elsewhere in the Income Tax Act that allow Canadians to shelter some retirement savings.

- Investments that are not on the **Designated Stock Exchange** list are not qualified investments for RRSPs and other tax-deferred plans. Although the removal of the foreign content limits was a very positive decision for Canadians allowing them to better diversify their savings, the Designated Stock Exchange list prevents Canadians from better diversifying their retirement savings beyond the Designated Stock Exchange List.

- **Former Bill C-10** which proposed changes to NRT and FIE rules was clarified by way of a Comfort Letter issued by the Department of Finance in April 2008. The members of the ICAC would appreciate confirmation of the direction the Department of Finance plans to take with

respect to this former Bill to ensure that exemptions provided for pensions and other retirement savings provided in the Comfort Letter and clarified in emails to the ICAC will become law. In addition, ICAC members invest funds for many hospital and university foundations and other tax exempt entities which are hoped to be exempt from the proposed new NRT rules.

The following are details of the 3 key issues.

1) Changes To The "150 Unit Holder Rule" In The Income Tax Act

An inability for seniors and Canadians saving for retirement to maximize investment opportunities could translate to an environment where retirees become less financially self-sufficient, less able to contribute to the federal government's tax base in retirement, and more dependent on government programs and services.

With the number of retirees set to increase dramatically as the baby boom generation enters retirement, it is in the government's best interest to put in place measures that serve to strengthen – not weaken – the financial independence of retirees.

Therefore, ICAC proposes that:

The Income Tax Act should be amended (Subsection 132(6) and Regulation 4801) to create tax fairness by making the threshold for commercial trusts to qualify as Mutual Fund Trusts reflective of investment realities.

This would be achieved by lowering the current 150 unit holder requirement to 50 unit holders. In addition, we propose that the "look through" principle should be revised to accommodate segregated funds holding RRSPs or pension plans (including those held through other trust vehicles such as Defined Contribution Pension Plans) to minimize the possibility of retirement savings being subjected to tax.

A provision in the *ITA* unfairly subjects some seniors and Canadians saving for retirement to less favourable tax treatment than other Canadians who invest in extremely similar pooled investment vehicles. The problem stems from a distinction in the Act between trusts that qualify for mutual fund trust tax status (MFTs) and those that identical in all respects other than having less than 150 unit holders – the prescribed and arbitrary number of unit holders necessary to achieve MFT status.

The arbitrary "150 unit holder" number was introduced to distinguish bona fide commercial trusts from personal or family trusts. While ICAC supports the need to prevent tax avoidance, the 150 unit holder rule penalizes investors in legitimate investment vehicles.

Three of the major discrepancies in fairness between trusts that qualify as MFTs, and those that do not are:

1. MFTs qualify for investment status for RRSPs, RRIFs, DPSPs and RESPs without the additional investment restrictions imposed on "registered investments"; and,

2. MFTs are exempt from Alternative Minimum Tax (if they qualify as MFTs throughout the year).
3. MFTs are permitted to use the Capital Gains refund mechanism.

The 150 unit holder rule fails to reflect the investment realities faced by Canadians, and their pension plans and investment advisors:

- Many Investment Counsellors and Portfolio Managers utilize unit trusts or pooled funds on behalf of their clients who are independent of each other as efficient pooling vehicles. These unit trusts are identical to mutual funds except that they do not have 150 unit holders. Like mutual funds, these funds are governed by a Trust Agreement and must have a Trustee;

- Under the current rules, even if there are 1000 members of a pension plan, a pooled fund in which the plan invests must treat the pension plan as a single unit holder for the purpose of determining its MFT eligibility; and,

- A common business practice is to keep funds small (e.g. some cap at $100 million) to allow the firm to be flexible with trades and to react quickly to changes in the market. When funds become too large, it is difficult to trade effectively as each trade has the potential to move the market. If a fund drops below 150 unit holders, it loses it MFT status and its investors are then subject to a tax disadvantage.

There would be minimal tax loss from a change to the 150 unit holder rule that restores tax fairness. In fact, a change would create a better environment for investment that would enable Canadians to optimize their savings. In addition, it would encourage new smaller entrants into the investment industry, further competition in the successful management of assets and increase overall asset management efficiency.

Negative effects of the 150 Unit Holder Rule

1. It restricts Canadians from being able to optimize their savings. While a fund that has less than 150 unit holders may offer the best group of investments, the unfair tax implications may rule it out as an option altogether.
2. If an MFT drops below 150 unit holders, the impact could be significantly detrimental on the remaining investors. For example, once an MFT drops below 150 unit holders, it could lose its qualification as an investment for an RRIF, RRSP, DPSP, or RESP. This would immediately trigger a 1% penalty tax per month on an RRSP or RRIF holder that continues to hold the units.
3. Former Bill C10 Impact – The Dept of Finance issued a Comfort Letter in April which provided an exemption from Bill C10 tax liability to most Canadian pension plans and some retirement savings. The Bill however did not protect Canadian RRSP's which may be mixed in funds with taxable investors. If the Bill is passed as is not withstanding the Comfort Letter, these Canadian's retirement savings may be subject to tax. The result of this remaining flaw in Bill C10 is that Canadian investment managers will be forced to split some of their "co-mingled" funds to protect the RRSP holders within the mixed fund from the tax liability potentially imposed by Bill C10. This will result in many funds dropping below the 150 unit holder threshold and these Canadians being subject to the tax implications outlined above.

4. It creates a barrier to foreign investment growth in Canada. For example, a small Canadian investment firm approached by a foreign pension plan to manage some Canadian assets may be forced to decline the business if (a) its pooled vehicles had less than 150 unit holders for fear that the non-resident investment would affect the tax treatment of unit holders under Part XII.2; and, (b) if it was not viable or effective to manage their assets on a segregated basis.

5. It leads to higher management fees for investors by creating obstacles for small advisors who have no choice but to pass on business to larger financial institutions. Small advisors' management fees are often 25 percent less than larger commercial mutual funds.

6. It results in an unworkable level of administration to the detriment of investors.

150 Unitholder Recommendation:

In light of the current economic crisis, we recommend that:

> ***Mutual fund tax status should be granted to a fund that has at least 50 unit holders; a "look through" principle should be incorporated for segregated funds holding RRSPs or pension plans (including those held through other trust vehicles such as Defined Benefit pension plans.)***

2. Expansion/Updating of Designated Stock Exchanges

The current list of designated stock exchanges requires expansion and updating to allow Canadians to adequately diversify their savings in different economies around the world. Given the economic downturn during the last year, diversification of capital is even more critical. The current list of 38 exchanges primarily consists of exchanges in North America (40%) and Europe (40%). This excludes many respected, well regulated and established exchanges in other parts of the world. Given Canada according to the United Nations is one of the most culturally diverse nations in the world, it is logical that many new Canadians may wish to invest part of their retirement savings in their country of ancestry.

The current process requiring foreign exchanges to apply for designation is neither practical nor feasible as it places the onus on countries to be aware of Canadian tax law restrictions and to be incented to apply for exchange designation. We are not aware of any other country that has this practice which makes it even more unlikely that a foreign jurisdiction would seek out "designation" to encourage local investment.

If the Department of Finance is not prepared to eliminate the restrictive list entirely in line with the elimination of the 30% foreign content limit, then we urge the Department of Finance to adopt a more reasonable assessment measure which does not create additional requirements on Foreign Stock Exchange Designation nor create practical obstacles to expanding the current list. One such method may to be accept exchanges in OECD member countries.

The 2005 budget took the important step of eliminating the foreign content limit for RRSPs and other tax-deferred plans. However, seniors and Canadians saving for retirement are still unable to optimize the foreign content portion of their investment portfolio due to the time it is taking to prescribe certain foreign stock exchanges under the *ITA*.

Currently, there are a number of foreign stock exchanges, such as AIM, which have yet to be prescribed for the purposes of the *ITA*. This means that the investments on these exchanges are not qualified investments for RRSPs or other tax-deferred plans, even though the government has removed the foreign content limit for those plans. From a practical point of view, a Canadian investment manager wishing to establish an "emerging markets" fund for their clients is restricted to the current list. This list excludes many respecting, growing emerging economies which are opportunities for Canadians to grow and diversify their savings. The list below identifies exchanges

ICAC members currently access for investment management purposes that are currently not Designated Stock Exchanges. The exchanges in blue are OECD countries; exchanges in red are OECD Accession Candidate countries and in green, Enhanced Engagement countries.

Argentina (Buenos Aires SE)
Belgium (Euronext Designated; Euroclear Not Designated)
Bermuda (Bermuda SX)
Brazil (Sao Paulo SE)
Bulgaria (Bulgarian Stock Exchange)
Chile (Santiago SE)
China (Shanghai (SSE), Shenzhen SE)
Colombia (Colombia Stock Exchange)
Czech Republic (Prague SE)
Egypt (Egyptian SE)
Greece (Athens SE)
Hungary (Budapest SE)
Iceland (ICEX)
India (National SE & Bombay SE)
Indonesia (Jakarta SX)
Japan (Tokyo SE Designated; Osaka SE Not Designated)
Malaysia (Kuala Lumpur SE)
Pakistan (Karachi SE)
Panama (BVP)
Peru (BVL)
Philippines (Philippines SE)
Portugal (Euronext Lisbon)
Russia (MICEX, RTS SE; SPBEX)
South Korea (Korea E)
Sweden (Stockholm SE Designated; Nordic Growth Not Designated)
Switzerland (SWX Designated; Switzerland Virtex Not Designated)
Taiwan (Taiwan SE)
Thailand (Stock Exchange of Thailand (SET))
Turkey (Istanbul SE).
United Kingdom (LSE Designated; AIM Not Designated)

ICAC strongly urges the government to accelerate the process to designate foreign stock exchanges for the purposes of the Income Tax Act to allow Canadians to take full advantage of international diversification of their assets. This is particularly critical at a time when interest rates are under 1 % and Canadians need options to ensure they have adequate savings for retirement.

Effects of the delay

1. Seniors and Canadians saving for retirement are unable to optimize their savings.
2. Investment Managers can not set up funds for Canadians to invest their retirement savings which include any of the foreign exchanges listed above.
3. Seniors and Canadians saving for retirement could be forced to take more risk than necessary with their savings. Because of the delay in prescribing certain foreign stock exchanges, some investors are unable to make particular foreign investments in their RRSP or other tax deferred plan that would enable them to obtain the optimal diversification of their portfolios assets.

Designated Stock Exchange Recommendation:

> **The ICAC recommends the Designated Stock Exchange list either be eliminated entirely OR be expanded to automatically include any exchanges in OECD member countries. In addition, consideration should be given to OECD Accession Candidate Countries & Enhanced Engagement Countries.**

3. Former Bill C10 – NRT/FIE Rules

We appreciate the Comfort Letter issued by the Department of Finance to the ICAC April 2, 2008 which provided some interim clarity in terms of two key exemptions provided on page 2 of the letter, namely:

- *"..the first amendment would involve an exemption from resident contributor and resident beneficiary status for most registered pension plans, the CPPIB (and similar provincial pension funds, and certain Canadian intermediaries (trust and corporations) in which these qualifying pension plans are the only holders of equity interest or participating debt. The exemption would not, however, apply to a plan that is a designated plan (as defined in subsection 8500(1) of the Income Tax Regulations), a plan that has fewer than 10 members (as defined in subsection 147.1(1) of the Act or a trust or corporation any of the activities of which is to administer, manage or invest the monies of a retirement compensation arrangements."*

- *"The second amendment would modify the provisions of paragraph (h) of the exempt foreign trust definition to include a non-resident commercial investment trust, without regard to whether the trust holds restricted property, in which the only Canadian resident investors are Canadian mutual funds (as defined in sections 131and 132 of the Act, and having at least 150 investors) whose investors are exclusively the pension plan entities that qualify for the exemption described above, registered retirement savings plans, and registered retirement income funds."*

In subsequent exchanges by email, the Department of Finance clarified that:

1) *"Regarding the first numbered paragraph of your e-mail below from earlier this afternoon, I can confirm that it is intended that the exemption identified in my letter to you of April 2, 2008 apply to the following "qualifying pension entities":*

   - *an RPP, other than a "designated plan" (as defined in subsection 8500(1) of the Income Tax Regulations) or a plan that has fewer than 10 members;*

   - *a trust (other than an "RCA trust" (as defined in subsection 207.5(1) of the Act)) or corporation (such as, for example, the Canada Pension Plan Investment Board, the Public Sector Pension Investment Board and the Caisse de dépôt et placement du Québec) established by federal or provincial legislation the principal activities of which are to administer, manage or invest the monies of one or more pension funds or plans established pursuant to such legislation; and*

   - *certain Canadian intermediaries – corporations and trusts (including segregated fund trusts) – in which qualifying pension entities are the only beneficiaries and holders of participating debt. "*

Mr. Ernewein further clarified by email that the third bullet under point 1 would include a unit trust in which qualifying pension entities are the only beneficiaries (and holders of participating debt).

2) *"As we have discussed and as noted above, it is intended that the reference to Canadian intermediaries in that letter include a segregated fund trust (i.e., a deemed trust under section 138.1*

of the Income Tax Act), but the exemption is not intended to apply in respect of other insurance contracts.

I can also confirm the accuracy of the comments in paragraph 3(a) of your e-mail, but note that the proposed relief is broader than your description in that not only RPPs, but any "qualifying pension entity" would be an acceptable investor for purposes of the modified paragraph (h) of "exempt foreign trust".

Finally, I appreciate your comments in paragraph 3(b) et seq of your message. "

As you can well appreciate, the markets require some certainty and many of our members are proactively trying to determine how they should invest certain funds in the interim. It is therefore important to understand the Department of Finance's intentions with respect to the former Bill C10; what amendments are being contemplated and are any other exemptions being considered which would provide relief from the NRT rules for tax exempt foundations. (eg. charities, hospitals, universities.)

Lastly we urge the Department of Finance when drafting revisions to consider any potential "cooling" effect the rules may have on Canadian investors being accepted into international funds. We understand there remain some international trusts who have been directed not to allow Canadian investors into the fund for fear of the negative tax impact on the entire fund that was contemplated in former Bill C10.

Concluding Remarks: We appreciate the consultation process the Department of Finance has taken with respect to Bill C10 and other issues and offer our assistance in future formulation of other Canadian financial and tax policies.