2007 Pre-Budget Submission

Brief to the House of Commons Standing Committee on Finance

Investment Counsel Association of Canada

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Executive Summary

The Investment Counsel Association of Canada (ICAC) – the representative organization for investment counsel and portfolio managers in Canada – seniors, Canadians saving for retirement, and the federal government share a common goal, which is to ensure that there are sufficient resources in place for retirement.

ICAC believes three key issues are preventing seniors and Canadians saving for retirement from being able to optimize their investments:

1. Legislation reintroduced as Bill C-10 (Bill C-33 in the previous Parliamentary session) unfairly captures pension plans, Registered Retirement Savings Plans, and tax exempt Canadians who hold certain "non-resident trusts" along with those who wrongfully evade paying their fair share of Canadian tax. The result is that if the legislation passes without amendment, these tax exempt vehicles and individuals will face a tax liability.

2. The "150 Unit Holder Rule" in the Income Tax Act, which serves as a 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.

3. Investments on certain foreign stock exchanges are not qualified investments for RRSPs and other tax-deferred plans, even though the government has removed the foreign content limits for those plans.

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 House of Commons Standing Committee on Finance recommend that:

1. Bill C-10, currently before the Senate, should be amended to ensure that tax exempt accounts are not inadvertently penalized along with those that wrongfully evade paying their fair share of Canadian tax. If Bill C-10 is passed without amendment, Canadian pension plans, Registered Retirement Savings Plans, and tax exempt investors may face a tax liability. The legislation must be brought in line with the exemptions provided for registered pension plans and other exempt taxpayers in the *Income Tax Act* with respect to investments in foreign investment entities.

2. The Income Tax Act should be amended to create tax fairness by making the threshold for commercial trusts to qualify as Mutual Fund Trusts reflective of investment realities.

3. The process to prescribe foreign stock exchanges for the purposes of the Income Tax Act should be expedited to allow seniors and Canadians saving for retirement to invest on those foreign exchanges in their RRSPs and other tax-deferred plans.

Recommendation #1: Bill C-10, currently before the Senate, should be amended to ensure that tax exempt accounts are not inadvertently penalized along with those that wrongfully evade paying their fair share of Canadian tax. If Bill C-10 is passed without amendment, Canadian pension plans, Registered Retirement Savings Plans, and tax exempt investors may face a tax liability. The legislation must be brought in line with the exemptions provided for registered pension plans and other exempt taxpayers in the *Income Tax Act* with respect to investments in foreign investment entities.

The Investment Counsel of Canada (ICAC) agrees with the general principle and spirit of Bill C-10, which is to close off-shore tax havens. However, the current wording of the legislation has the effect of penalizing pension plans, Registered Retirement Savings Plans (RRSPs), and other legitimate tax exempt Canadians, along with those who should be captured by the legislation – those who knowingly avoid paying their fair share of Canadian taxes.

Registered pension plans, RRSPs, and certain other Canadians are exempt from tax under the *Income Tax Act*. This has not been taken into account in Bill C-10 with respect to a specific foreign investment vehicle – "Non-Resident Trusts" (NRTs).

As such, the magnitude of the tax liability and/or the sub-optimal allocation of investments that will be created if this legislation is not amended are substantial. Pension plans manage $1.2 trillion of assets in Canada and mutual funds account for an additional $400 billion of registered retirement savings.

There would be <u>no loss</u> of expected revenue to the federal government by adopting the suggested amendment for registered pension plans and exempt taxpayers which are already exempt from tax. This amendment is needed to prevent the unintended potential consequences of this legislation and to bring it in line with the exemptions provided for registered pension plans and other exempt taxpayers in the *Income Tax Act (ITA)*, generally and with respect to the application of the foreign investment entity rules.

Unintended Potential Impacts of Bill C-10

1) A reduction in the overall assets of pensioners and hardworking Canadians saving for retirement. This would be the result of a significant tax liability on investments that currently appear to be tax exempt under the *Income Tax Act*, but are not exempt under Bill C-10. In addition, while pension plans could screen investments so as not to incur any tax liability, this limits the investment vehicles available to such plans.

2) Pension plans already having problems with solvency could face increased difficulties meeting the retirement needs of their pensioners. Again, this would be the result of a significant tax liability on investments that currently appear to be tax exempt under the *Income Tax Act*, but are not exempt under Bill C-10.

3) Pensioners and Canadians saving for retirement could be forced to take more risk than necessary with their savings. Bill C-10 would have the effect of preventing the proper diversification of portfolios in certain foreign or smaller asset classes where a pooled investment may be the only, or the optimal, vehicle.

4) Pensioners and Canadians saving for retirement would have opportunities reduced to increase their savings. Again, this would be the result of being prevented from diversifying into certain foreign or smaller asset classes where a pooled investment may be the only, or the optimal, vehicle.

5) Pensioners and Canadians saving for retirement could face higher administrative fees on their savings, which would reduce their portfolio assets. If Bill C-10 becomes law without the necessary amendment, pension plans and portfolio managers will need to perform additional due diligence before investing in a foreign collective investment vehicle to determine whether it will be subject to the rule.

Proposed Amendment

In order to prevent the unintended potential effects of Bill C-10 on seniors and Canadians saving for retirement, the legislation must be amended to bring it in line with the exemptions provided for registered pension plans and exempt taxpayers under the *ITA* that invest in foreign investment entities.

An amendment to the *ITA* as new subsection 94(2.1) is suggested along the following lines:

> *In determining whether any entity is a resident contributor to a particular trust or a resident beneficiary under a particular trust, each contribution made or deemed to be made by an exempt taxpayer to the particular trust shall be deemed not to have been made.*

Recommendation #2: The Income Tax Act should be amended to create tax fairness by making the threshold for commercial trusts to qualify as Mutual Fund Trusts reflective of investment realities.

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.

Two 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).

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. 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.

4. 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.

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

Proposed Amendment

ICAC believes that the federal government must make an amendment to the *ITA* to restore tax fairness. ICAC recommends the amendment be along the following lines:

> *Mutual fund tax status should be granted to a fund that has at least 10 unit holders/shareholders, or to a pension plan with a significant level of membership, that are unrelated as defined under ITA.*

Recommendation #3: The process to prescribe foreign stock exchanges for the purposes of the Income Tax Act should be expedited to allow seniors and Canadians saving for retirement to invest on those foreign exchanges in their RRSPs and other tax-deferred plans.

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 those 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.

ICAC strongly urges the government to accelerate the process to prescribe foreign stock exchanges for the purposes of the Income Tax Act to allow Canadians to take full advantage of international diversification of their assets.

Effects of the delay

1. Seniors and Canadians saving for retirement are unable to optimize their savings. Certain investments on foreign exchanges that are not yet prescribed under the *ITA* may be perfectly suited to a particular investor's portfolio. However, because of the delay in prescribing the exchange under the *ITA,* they are not qualified investments for an RRSP or other tax deferred-plan.

2. 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.