2008 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 has for the past few years been working on 3 key issues which prevent seniors and Canadians saving for retirement from being able to optimize their investments:

- 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.
- Working with the Dept. of Finance and the Senate on finalizing amendments and/or comfort letters to Bill C-10 to ensure Canadian pensions and retirement savings are not subject to tax

The focus of this brief will be on the third and equally important and somewhat related issue –

Recommending changes to the "150 Unit Holder Rule" in the Income Tax Act, which currently serves as a threshold for trusts to qualify as Mutual Fund Trusts. The current threshold of 150 unit holders 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.

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:

> **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 threshold to 10 unrelated unitholders or *to a pension plan with a significant level of membership, that are unrelated as defined under ITA.***

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. 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.

Concluding Comments

ICAC believes that the federal government must make an amendment to the *ITA* to restore tax fairness. Seniors and Canadians saving for retirement must be able to maximize investment opportunities to ensure their future financial self-sufficiency, their ability to contribute to the federal government's tax base in retirement, and to minimize their dependence on government programs and services.

It is in the government's best interest to put in place measures that serve to strengthen – not weaken – the financial independence of retirees and to improve tax fairness for all Canadians saving for retirement.

This can be achieved by lowering the 150 unit holder rule which will ensure fair taxation and access by Canadians to funds of different size and will minimize unexpected and unfair tax liability.

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.*