PMAC
PORTFOLIO MANAGEMENT ASSOCIATION OF CANADA
Advancing Standards™

VIA E-MAIL

February 19, 2020

Mr. Ted Cook
Director General, Tax Legislation
Department of Finance Canada
Tax Legislation Division
140 O'Connor Street
Ottawa, Ontario
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Delivered via Email: budget2020@canada.ca

Dear Sirs and Mesdames:

Re: Pre-budget Consultations 2020

OVERVIEW

The Portfolio Management Association of Canada (**PMAC**), through its Industry, Regulation & Tax Committee, is pleased to have the opportunity to provide comments to the Department of Finance Canada (**Finance**) regarding Pre-budget Consultations 2020 (the **Consultation**).

As background, PMAC represents 280 investment management firms that collectively manage over $2.8 trillion in assets under management, all of which are registered as portfolio managers with one or more of the Canadian Securities Administrators (**CSA**). PMAC members manage investment portfolios for private individuals, institutions, foundations, universities and pension plans.

URGENCY OF TAX FAIRNESS FOR INVESTORS IN BUDGET 2020

Our submission is focused on two specific ways that we believe Finance can help strengthen retirement savings for all Canadians. PMAC's recommendations are also squarely focused on tax fairness and leveling what is currently an uneven playing field between different types of investors. Specifically, these recommendations would treat investors in unit trusts commonly referred to as "**pooled funds**" on an equal footing with those in mutual fund trusts (**MFTs**) and segregated funds.

PMAC is asking Finance to modernize and create tax fairness for individual investors and Canadian businesses by implementing two amendments. These amendments are designed to fix serious flaws in the *Income Tax Act* (Canada) (**ITA** or **Act**) for the benefit of Canadians saving for retirement. These changes are also intended to enhance the competitiveness of the Canadian markets, as well as that of asset managers and employers working to help investors meet their savings goals. Included as **Appendix A** to this submission is a breakdown of the Canadian managed money landscape.

Importantly, PMAC's recommendations do not require any Federal Budget expenditure.

The only potential loss of tax revenue would come from Canadians' pensions and personal savings in pooled funds. Retirement savings are being depleted as a result of penalty taxes for administrative and other arbitrary barriers to pooled funds complying with the current ITA requirements. These ITA requirements are out of step with international tax rules, ultimately hurting Canada's competitiveness.

This topic has been the focus of many previous pre-budget submissions by PMAC. There is some urgency however in this tax year which we hope to be addressed in Budget 2020. This urgency is set out by way of example in **Appendix B**. PMAC has been engaged in on-going, valuable conversations with Finance with respect to the need to treat investors in pooled funds in the same way as those that are invested in MFTs (and in some cases, segregated funds), based on the very technical differences between these types of investment vehicles. PMAC has consistently taken the position that pooled funds and MFTs ought to be treated similarly for tax purposes, for the benefit of investors. PMAC has also responded to Finance's questions about any potential unintended consequences that could arise out of our proposals – both to Finance and to investors. We believe that these answers have satisfied Finance as to the soundness of our proposals and we ask Finance to seize this moment to correct this unfairness to investors in Budget 2020.

We wish to stress that only a relatively small portion of pooled fund assets may be impacted by PMAC's "look-through".

KEY RECOMMENDATIONS

We ask Finance to include the following in Budget 2020:

1. **Adopt a "Look-Through" for pooled funds**: Adopt PMAC's request for a "look-through" to underlying investors in the pension plans held in the pooled fund. A look-through would allow most pooled funds holding pension plan investments to meet the 150 unit-holder test, resulting in the same tax treatment as MFTs and segregated funds – which would prevent unfair tax penalties, and allow portfolio diversification and economies of scale that ultimately benefit investors; and

2. **Expand Trust Reporting Exemption**: Include pooled funds and exchange traded funds (**ETFs**) in the exemption from the requirement to disclose beneficial ownership information. There is no policy rationale for treating pooled funds and ETFs differently than MFTs and segregated funds in this respect.

Each recommendation is set out in more detail below.

Given the centrality of pooled funds and tax fairness policy to our submissions, we have included a general discussion about the importance of pooled funds to Canadian savers below.

Pooled funds are very similar to mutual funds but are offered pursuant to exemptions from the prospectus requirements under securities laws. Pooled funds are investment funds that are a popular investment choice for employer-sponsored defined contribution pension plans. This is because they are typically offered at substantially lower costs than mutual funds and give middle class Canadians access to different asset classes.

DISCUSSION OF KEY RECOMMENDATIONS

1. Look-through to super investors

Benefit to Canadians

PMAC believes that amendments to the ITA allowing pooled funds to look through "super investors" (which are other widely-held investments funds and deferred plans (e.g. pension plans)) to underlying investors in the pooled fund will create tax policy fairness for investors in pooled funds. Here is how Canadians would benefit:

- Enable pooled funds to merge on a tax-deferred basis, as permitted for MFTs and insurance segregated fund products, in order to avoid two taxable events for retired employees in pooled pension products (see **Appendix B**);
- Avoid retirement savings being inadvertently subject to penalty taxes when a fund drops below 150 unitholders and loses its MFT status;
- Keep fund costs low for the benefit of investors and remain operationally efficient, with easier ability for pooled funds to achieve MFT status; and
- Allow access to significantly more international markets potentially providing better investment returns and diversification.

Solution – "look through"

We are recommending an amendment to the ITA that would enable the "look through". Pooled funds are generally designed for large institutional investors, which hold their investments in the pooled fund via another capital aggregation vehicle (such as a pension trust or pension corporation). These pension plans often have hundreds or thousands of beneficiaries which under the current Act, are not individually recognized but are instead counted as one single unitholder. This creates unfairness, penalty taxes and additional compliance and trading execution costs for those Canadians whose retirement savings are invested in such plans.

Leveling the playing field to enable a look-through to the underlying investors in the pension plans would enable pooled funds to more readily obtain MFT status. This amendment would resolve a number of the above tax issues for a large majority of pooled funds.

Our recommendations will also encourage new smaller entrants into the investment industry, further competition in the successful management of assets and increase the attractiveness of Canadian pooled funds to international pension plans and private investors.

Current unfair treatment of investors in pooled funds that are not MFTs

1. The Act causes a detriment to investors in a deferred plan (i.e. those invested in an RRIF, RRSP, DPSP, or RESP), if a pooled fund does not obtain or loses its MFT status (i.e. by not having, or falling under, 150 unitholders). Where a pooled fund loses its classification as a qualified investment, this could trigger an exodus of deferred plan investors from the fund, who have to redeem in order to avoid a penalty tax. The penalty tax can arise within the fund if it holds non-qualified investments, and the penalty tax is passed on to the investor. These penalty taxes can be significant and result in the erosion of precious retirement savings for Canadians.

2. The Act 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 funds have less than 150 unitholders for fear that the non-resident investment would suffer potentially higher withholding taxes on distributions; and, (b) it was constrained in its ability to execute on its investment strategy mandate due to limitations in the type of investments and markets it can access.

The Act restricts Canadians from being able to optimize their returns on investment savings; current rules can also create obstacles for small investment firms, which have no choice but to pass on business to larger financial institutions – this leads to higher management fees for investors, since small investment firms' management fees are often 25 percent less than commercial mutual funds run by larger institutions.

In summary, our recommendation would help Canadians saving for retirement as well as modernize and benefit Canada's tax regime by:

1. Enhancing and promoting Canadians' ability to save for a comfortable retirement;

2. Enabling Canadians to save for retirement without fear of unreasonable fees or penalty taxes;

3. Improving the competitiveness of Canadian pooled investment funds both in Canada and internationally;

4. Helping small and mid-size businesses provide affordable, low cost employer sponsored retirement plans for their employees; and

5. Putting smaller firms on a level playing field with established incumbents in offering new pooled funds.

The government has the opportunity to resolve long-standing issues in the ITA that negatively impact investors and the Canadian market. It is in Canadians' best interest for the government to enact measures that strengthen – not weaken – the competitiveness and fair tax treatment of pooled funds to ensure the adequacy of Canadians' retirement savings.

2. Trust reporting requirement exemption should include pooled funds and ETFs for fairness

In 2018, Finance proposed beneficial ownership reporting requirements for certain trusts. Consistent with PMAC's pre-budget submission in 2018 on this issue, we continue to believe that this particular proposal would adversely impact the ease of doing business in Canada to the detriment of the many Canadian savers that are invested pooled funds and ETFs.

Expanding the exemption available to MFTs and segregated funds from these reporting requirements to pooled funds and ETFs is requested on an urgent basis in Budget 2020; otherwise, pooled fund and ETF managers will be required to build and implement systems to collect beneficial ownership information in time for the 2021 effective date, all without a principled reason for requiring them to do so.

Pooled Fund Exemption

PMAC supports Finance's efforts to bolster information gathering to improve corporate transparency. However, we believe that there is an important fairness issue created by the proposed beneficial ownership reporting requirements for certain types of trusts set out in the Consultation.

The Budget 2018 proposed beneficial ownership reporting requirements for certain trusts for 2021 and subsequent taxation years. Our understanding is that these requirements were not intended from a tax policy perspective to impact commercial investment fund products. These reporting measures would require that certain trusts provide additional information about beneficial ownership by filing a T3 return where such a reporting obligation does not currently exist. The measures apply to express trusts resident in Canada and to non-resident trusts that are currently not required to file a T3 return. The supplementary information[1] in respect of Federal Budget 2018 noted that the new reporting is designed to determine taxpayer liabilities, as well as to counter money laundering and other criminal activities. Budget 2018 also proposed the introduction of monetary penalties for the late filing of such T3 returns.

Importantly, however, the proposed requirements would exempt certain trusts from the proposed reporting requirements. Included in the list of exempted trusts are MFTs and segregated funds. Pooled funds, however, not been carved out and, as such, would be required to report the identity of all trustees, beneficiaries and settlors of the trust, as well as the identity of each person who has the ability to exert control over trustee decisions regarding the appointment of income or capital of the trust.

We believe that pooled funds should be carved out based on the same rationale that MFTs and segregated funds were carved out. Without this exemption, the reporting measures, as currently drafted, would adversely impact the ease of doing business in Canada to the detriment of the many Canadian savers that are invested in pooled funds.

[1] At page 15.

If there is a principled policy reason to exclude MFTs and segregated funds from this type of beneficial ownership reporting, the same policy principle must also extend to pooled funds which are, in essence, the same type of trust vehicle. We believe that any undue compliance burden on pooled funds in this respect is unwarranted and is likely an unintended negative consequence that should be corrected well in advance of the coming into force of these reporting requirements.

ETFs

PMAC also has concerns that certain ETFs do not qualify as MFTs (by virtue of not having 150 unitholders at a given time) and do not fit under any of the other proposed exemptions from the beneficial ownership reporting requirements set out in the Consultation. For units of trusts traded on stock exchanges, the fund manager does not have visibility into the ultimate beneficial holders of the trust. This is because ETF units are typically held by one registered holder, The Canadian Depository for Securities Limited (**CDS**). In order to invest in an ETF, an account with a broker-dealer would need to be opened. Thus, CDS intermediates between the fund manager and broker-dealers who have the ultimate contractual relationship with the underlying beneficial owners of the ETF units. An ETF manager would not have access to the beneficial ownership information of the ETFs they manage and the ETF industry would need to implement an operational solution to meet the proposed reporting requirement under the Consultation.

PMAC'S REQUEST

We request that Finance include an additional exemption from the beneficial ownership reporting requirement for trusts that qualify as an "investment fund" (without regard to the requirement to follow a reasonable policy of investment diversification under subparagraph (b)(iii)) as defined in subsection 251.2(1) of the *Income Tax Act* (Canada)) to ensure that pooled funds and ETFs are excluded from this reporting requirement, in recognition of similarities between these types of trusts and MFTs, as well as to reduce regulatory costs passed on to investors in investment funds.

CONCLUSION

Why action is needed in Budget 2020

Currently the ITA includes a number of complex, out-of-date tax rules which have not kept pace with their international counterparts, or with the evolution occurring in the investment fund industry. The ITA is also unintentionally harming investors in pooled funds without any policy or other rationale. For tax purposes, pooled funds are not afforded the same benefits as mutual funds unless they have a minimum of 150 unitholders, allowing them to achieve MFT status.

Budget 2020 must include amendments to address the following problems – currently, the ITA:

1. Harms investors in pooled funds through unfair tax treatment compared to investors in MFTs; limits diversification and investment returns and, in many cases, imposes punitive

tax penalties as a result of arbitrary tax rules. This ultimately reduces Canadians' retirement and other savings;

2. Inhibits the ability of small and mid-sized Canadian employers to offer low cost retirement savings plans for their workers through arbitrary tax rules and restrictions;
3. Inhibits the competitiveness of small and mid-sized Canadian asset management firms by making it harder for them to launch and maintain funds that qualify for MFT status;
4. Proposes to impose a reporting burden on pooled funds and ETFs that MFTs that similar funds have been exempted from without a policy rationale for doing so; and
5. Impedes Canada's ability to attract investment capital from international pension plans and investors.

Thank you for the opportunity to participate in this Consultation. We would be pleased to continue the dialogue on this important issue and discuss the recommendations included in this submission in more detail.

If you have any questions regarding this submission, please do not hesitate to contact Katie Walmsley (kwalmsley@pmac.org) at (416) 504-7018 or Margaret Gunawan (Margaret.gunawan@blackrock.com) at (416) 643-4083.

Yours truly;

PORTFOLIO MANAGEMENT ASSOCIATION OF CANADA

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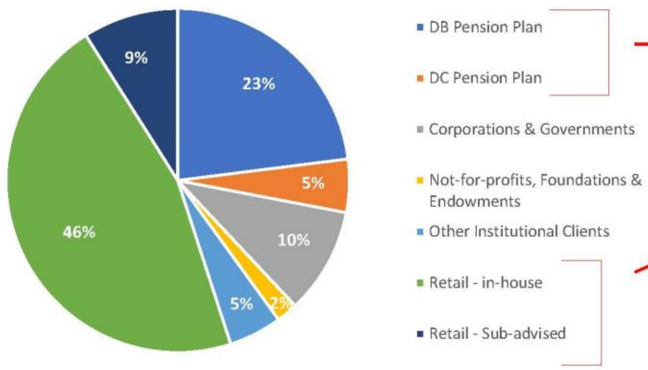
APPENDIX A

The Canadian Managed Money Landscape

Data provided by: ISS Market Intelligence Survey – June 2019



Assets in DB and DC Pension Plans include:
Predominantly pooled funds (equities, fixed income, private equity, other alternatives) which may be impacted by "look through" and stand-alone equity and fixed income securities; totalling $1.033 m or 28 % of total managed assets

Assets in Retail include:
Private investment counsel (PIC), mutual funds and discretionary brokerage would be in the Retail categories depending if assets are internally managed (in-house) or a sub-advisor is used to manage the assets. Not impacted by "look through" as not used by institutional investors

Private Investment Counsel totalled $379.6 billion at June 2019.

Investor Type	Assets ($ millions) As of June 2019
DB Pension Plan	$862,958
DC Pension Plan	$170,708
Corporations and Governments	$367,944
Not-for-profits, Foundations & Endowments	$71,758
Other Institutional	$200,958
Retail – In-house	$1,729,606
Retail - Sub-advised	$320,909
Grand Total	$3,724,841

APPENDIX B
Unfair Tax Treatment of Investors in Defined Contribution Pension Plans

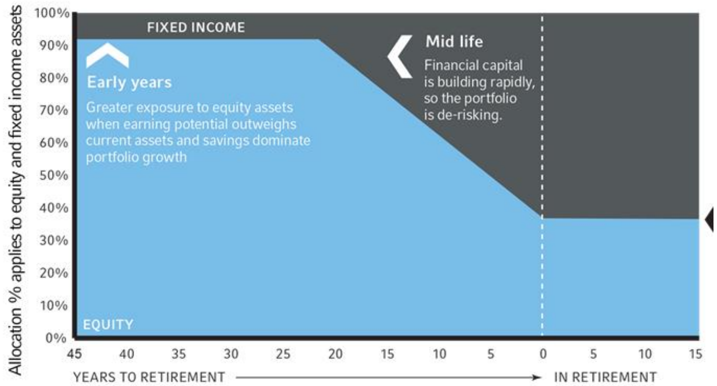
THE PROBLEM: Currently, well over 1,000,000 Canadians are losing a portion of their retirement savings due to unfair tax rules. People who invest their pension savings in commonly used investment vehicles called target date funds (**TDFs**) are at an unfair disadvantage compared to those who invest in mutual funds or segregated funds[2]. Under the *Income Tax Act*, a TDF is not defined as a mutual fund trust (**MFT**). MFTs receive some beneficial tax treatment, such as the ability to merge funds on a tax-deferred basis and to invest in securities not limited to those on the Designated Stock Exchange (DSE) list. There is no policy rationale for treating Canadian savers differently based on whether their pension is held in a TDF or in an MFT. Our proposal would make retirement more affordable and treat Canadians in different retirement savings vehicles more fairly.

IMPACT ON CANADIAN SENIORS AND RETIREES - AN EXAMPLE: Mary from Regina has worked her entire career at a Canadian agricultural company. The company provides employees with a defined contribution pension plan (**pension**). During her tenure, Mary has contributed $36,793 of her salary to the pension which is invested in a TDF. When combined with her employer's contributions, at age 64, Mary has $111,575 in her pension. Approximately 10% of Mary's pension is made up of non-registered investments[3]. Unlike other Canadians whose savings are held in investment vehicles like mutual funds and segregated funds, by the time Mary retires at 65 in 2020, she will be subject to tax twice on the non-registered portion of her investments in the TDF. First, when her TDF rolls into a long-term retirement fund (**Retirement Fund**) and second, when she withdraws money to support her living and health care costs to fund her retirement. This double taxation means that Mary will have less to fund her retirement. In addition to these tax consequences, Mary's pension is negatively impacted by the DSE (as described further below).

TARGET DATE FUNDS

TDFs are a very popular investment choice for defined contribution pension plan administrators because they provide over 1,000,000 investors access to a broad range of investment strategies at a low cost, which ultimately benefits retirees. For example, BlackRock Canada (**BlackRock**) alone manages CAD $29 billion in TDFs for Canadians. We are using BlackRock's TDFs and Retirement Fund in this example for illustrative purposes. TDFs are designed to adjust their asset mix as an employee ages to meet typical risk and return objectives. For example, while an employee is in their 20s and 30s, the TDF invests more heavily in equity securities. Towards retirement, the TDF de-risks by shifting its asset mix to provide income and moderate long-term growth of capital for investors like Mary who are beginning to withdraw their money. At the target date, the TDF rolls into the Retirement Fund – a long-term fund whose conservative asset mix remains static over time.

[2] Segregated funds are investment funds offered by way of an insurance contract with an insurance company.
[3] There are many employee-sponsored defined contribution pension plans in Canada that offer non-registered investments. These types of taxable investments are widely available to many employees as a vehicle to help them save for and fund their retirement, senior health care, and other important life events.



TDFs wind up at a pre-determined date that coincides with the investor's retirement. In this case, Mary's fund was scheduled to wind up in December 2019 and automatically merge into a Retirement Fund. The securities and allocations held in Mary's maturing TDF and the Retirement Fund are identical at that point, so it becomes operationally inefficient to maintain two separate but identical funds.

BlackRock's solution to this public policy problem has been to defer the merger of the TDF into the Retirement Fund for a period of 5 years to allow investors like Mary time to manage the negative financial impact resulting from the unfair tax treatment on her non-registered investments. However, running both the TDF and Retirement Fund creates increased operating expenses and fund costs for investors. For Mary, this means that she will bear an increasing proportion of the TDF's fund operating costs as other investors withdraw their money from the TDF to fund their retirement. Had the TDF been able to merge on a tax-deferred basis into the Retirement Fund, there would be more money in the resulting fund, reducing the operating costs borne by Mary.

THE SOLUTION: We recommend modifying the tax rules via a "look-through"[4] so that all Canadian investors are treated equally, whether their pensions are invested in TDFs or mutual funds and segregated funds. As detailed below, this will result in higher pension savings to help fund Canadians' retirement needs.

For middle class investors like Mary, the look-through would result in four positive outcomes:

1) **No double taxation of non-registered investments -** Mary's TDF could merge into the Retirement Fund on a tax-deferred basis – in the same way that MFTs and segregated funds can. This means that Mary will not face negative tax consequences and be forced to forgo money that could otherwise be spent on costly senior health care and other important life events.
2) **Lower costs when merging identical funds –** Mary's TDF could merge with the Retirement Fund when she retires so Mary would benefit from paying lower operational

[4] The "look through" would count each individual pension holder, instead of just the pension, which would result in the TDF having sufficient investors to qualify as an MFT (150 unitholders).

and management costs on her Pension resulting from the efficiency created by the larger Retirement Fund.

3) **More international pension plan diversification –** Current tax rules allow typical TDFs to hold only securities listed on the DSE. This means that TDFs are not able in invest in certain emerging market equities listed on exchanges not included on the DSE list (such as exchanges in India, Indonesia, Malaysia, the Philippines, Taiwan or Thailand)[5]. The "look-through" will remove this restriction and give TDFs the same access to important markets as other types of funds. Portfolio diversification through access to different markets and industry sectors is critical to optimizing the risk/return trade-off.

4) **Higher investment returns due to lower fund management costs –** Because TDFs are limited to investing in securities on the DSE list, portfolio managers seeking diversification in certain foreign markets can only access these markets by purchasing Exchange Traded Funds (**ETFs**). This is because the TDF can purchase an ETF that trades on a U.S. stock exchange (which is part of the DSE list). However, ETFs are more costly to use, primarily because of their embedded management expense ratio. Using just the BlackRock TDF as an example, investors would save approximately CAD $11 million in annual costs[6] by allowing the TDF to directly access foreign market equities, instead of having to use ETFs to do so. By allowing the TDF to invest directly into emerging markets in the same way as mutual funds and segregated funds, Mary's TDF will not incur the costs of an ETF and the overall value of her Pension would increase.

[5] For context, this means that BlackRock's Target Date fund cannot access approximately 68.7% of BlackRock's emerging market pooled fund investments.

[6] Using the Blackrock TDF as an example, the TDF annually incurs an additional CAD $11 million in costs to investors, primarily as a result of the ETF's embedded management expense ratio – costs that would not have been incurred had the emerging market portfolio securities been held directly.