PMAC
PORTFOLIO MANAGEMENT ASSOCIATION OF CANADA
Advancing Standards™

VIA WEB PORTAL

February 25, 2022

The Honourable Chrystia Freeland
Deputy Prime Minister and Minister of Finance
Department of Finance Canada
90 Elgin Street,
Ottawa, Ontario
K1A 0G5

Dear Minister:

Re: Pre-Budget Consultations 2022

The Portfolio Management Association of Canada (PMAC) represents over 300 investment management firm members that collectively manage $3 trillion in assets for pension plans, endowments, individual and group RSPs, and other investments across Canada.

We are writing to ask you to change the tax regulations for pooled funds that unintentionally treat millions of Canadian savers, including tens of thousands of Canadian retirees, unfairly every year. This will not involve any budget expenditure. All that is required is a small amendment to Regulation 4801 under the *Income Tax Act* (Canada) (the **Act**).

Why action is needed in Budget 2022

For tax purposes, pooled funds are not afforded the same benefits as mutual funds and segregated funds unless they have a minimum of 150 unitholders, allowing them to achieve Mutual Fund Trust (**MFT**) status. A simple amendment to Regulation 4801 creating a "**look through**" to the underlying investors would recognize that many of these pooled funds are indeed widely-held funds that should be afforded the same tax treatment as a MFT in order to achieve tax parity across investment funds.

Without action now, Canadians with retirement savings in these vehicles could be faced with surprise tax costs and will continue to be restricted from further diversifying their retirement investments internationally.

This issue is explained in further detail below and in the attachments to this letter.

The issue of policy unfairness is this: thousands of small and mid-sized businesses provide pension plans and other savings vehicles to their employees.[1] These savings vehicles are aggregated into regulated and professionally invested unit trusts called "**pooled funds**". These pooled funds are like mutual funds and segregated funds – except in one crucial regard.

For tax purposes, for funds to be considered true MFTs, they must have a minimum of 150 unitholders to obtain the tax and investment benefits that MFT status affords. The problem is the way that unitholders are counted. For example, without the "look through", a pension plan, which could include 1000 individual beneficiaries, is counted as 1 unitholder – not 1000. In contrast, a retail mutual fund that has 1000 individual investors, is considered to have 1000 unitholders. It is therefore much more difficult for the pooled funds to reach and maintain the 150 unitholder threshold compared to a mutual fund.

There is no public policy benefit to this differential treatment. While segregated funds were given MFT status in the 2017 federal budget, pooled funds were left out. Each year, as more and more Canadians enroll in pooled retirement and savings funds, the unfairness grows.

The lack of MFT status for pooled funds results in a number of unfair consequences compared to mutual funds and segregated funds.[2]

As noted above, it is more difficult for pooled funds to reach and maintain the 150 unitholder threshold. There can be negative tax consequences to investors in the funds when the number of unitholders falls below 150.

The portfolio investments of pooled funds that include RRSPs, RRIFs and other registered accounts, can only be made from securities offered on a set list of stock exchanges (the Designated Stock Exchange List (**DSE**));[3] otherwise, the funds and their individual investors are subject to a penalty tax, which can be significant and would erode the retirees' precious retirement savings.[4] This limitation also prevents the funds from diversifying their investing in potentially lucrative overseas markets in a cost-effective manner. However, mutual funds and segregated funds can invest in securities traded on exchanges the world over and are not subject to such penalties.

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[1] Please see page 8 for a breakdown of the Canadian managed money landscape.
[2] Please see page 5 for an example of this differential treatment
[3] Please see page 9 for a map of the current DSE countries
[4] While the budget proposals introduced in 2021 would only apply penalty taxes to registered plan holders, this proposal fell short of recognizing that as a fiduciary, the fund cannot incur penalties in the fund that only apply to certain investor groups. Incurring the penalty would essentially mean the fund is not in compliance with the Act requirements for RI funds to only hold investments on the DSE. Therefore, the proposed legislative change would not alleviate the unfair treatment of pooled funds.

Pooled funds need to merge from time to time, to reduce the burden of costs on remaining investors in the fund as individual beneficiaries retire and withdraw their savings from the fund. However, pooled funds can't merge with other pooled funds without triggering a taxable event. This taxable event, which would occur with no action taken by the individual investor, may leave the investor with a significant tax cost. While some retirees will be able to access tax planning advice to manage this outcome, others may not. Mutual funds and segregated funds that are MFTs can merge without incurring such a taxable event.

To correct the inherent unfairness of the existing regulations, we are asking the Department to adopt a "look-through" strategy for pooled funds, to the underlying beneficiaries of these pension plans and other savings programs. Rather than viewing a pension plan in a pooled fund as one single unitholder, the "look-through" would recognize the fact that the pension plan may include hundreds of individual retirees who are the beneficiaries of those plans. The pooled fund is in fact a widely held fund, and there is no policy reason for it not to qualify as a MFT.

A "look through" would not involve any change in tax policy or financial cost, and would address all of the primary inequalities listed above:

1. No surprise tax costs for unitholders;
2. More cost-effective investment diversification for fund managers as a result of investments not being limited to the DSE list;
3. Ability to merge on a tax-deferred basis.

In summary, the look through would help Canadians saving for retirement as well as modernize 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 unforeseen taxes which are beyond their control;
3. Helping small and mid-size businesses provide affordable, low-cost employer-sponsored retirement plans for their employees.

The government has the opportunity to encourage Canadians to save for retirement and help companies provide cost-effective savings vehicles for their employees. This recommendation is a small fix that is not a change in tax policy but simply a clarification of the method of counting unitholders in pooled funds that recognizes the thousands of individual investors in these funds.

Implementing the look through recommendation will resolve long-standing issues in the Act that negatively impact savers and retirees. 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. We believe the look through does just that.

CONCLUSION

A simple amendment to Regulation 4801 creating a look through to underlying investors would correct an issue of tax policy unfairness. This amendment would recognize that many pooled funds are widely-held funds that exceed the 150 unitholder threshold and should be afforded the same tax treatment as a MFT.

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) 560-9419 or Margaret Gunawan (Margaret.gunawan@blackrock.com) at (416) 643-4083.

Yours truly,

PORTFOLIO MANAGEMENT ASSOCIATION OF CANADA

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Further Background & Analysis

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[1]. 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[2]. 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).

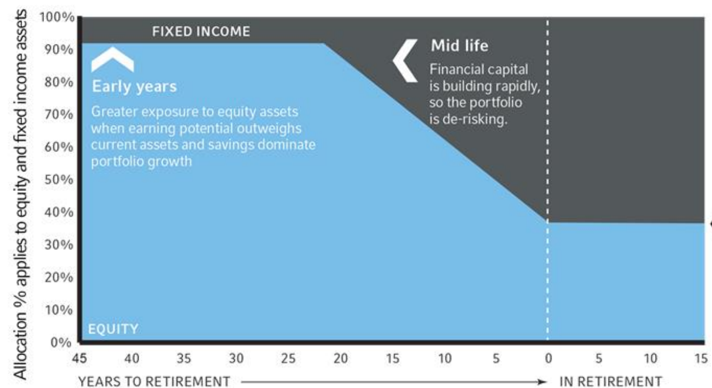
TARGET DATE FUNDS

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

[1] Segregated funds are investment funds offered by way of an insurance contract with an insurance company.

[2] There are many employer-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.

date, the TDF rolls into the Retirement Fund – a long-term fund whose conservative asset mix remains static over time.



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"[3] 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.

[3] 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).

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

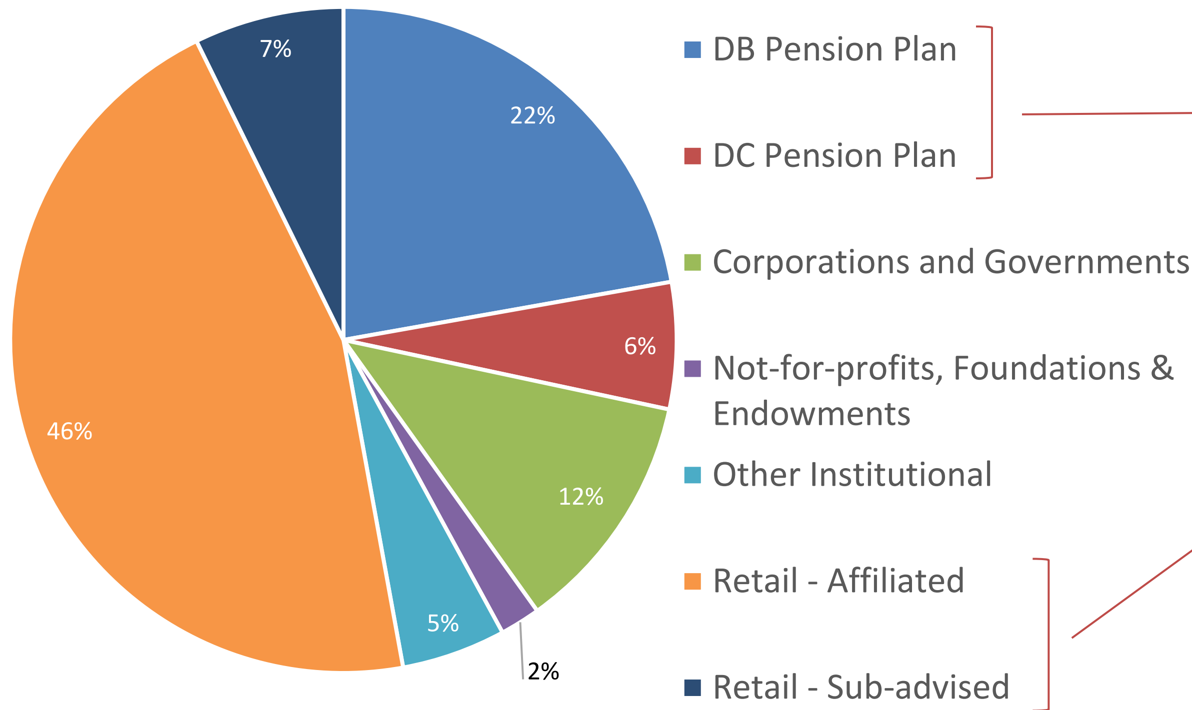
3) **More international pension plan diversification –** Current tax rules allow typical TDFs to hold only securities listed on the DSE. This means that TDFs are not able in invest in certain emerging market equities listed on exchanges not included on the DSE list (such as exchanges in India, Indonesia, Malaysia, the Philippines, Taiwan or Thailand)[4]. 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[5] 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.

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

[5] 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.

Canadian Money Manager Landscape, June 2021. Source: *Investor Economics Managed Money Research 2021*



Assets in DB and DC Pension Plans include: Predominantly pooled funds (equites, fixed income, private equity, other alternatives) which may be impacted by "look through" and stand-alone equity and fixed incomes securities totaling 28% of total managed assets.

Assets in Retail include: Private investment counsel (PIC), mutual funds and discretionary brokerage would be in Retail categories depending on 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.

Assets in millions of dollars

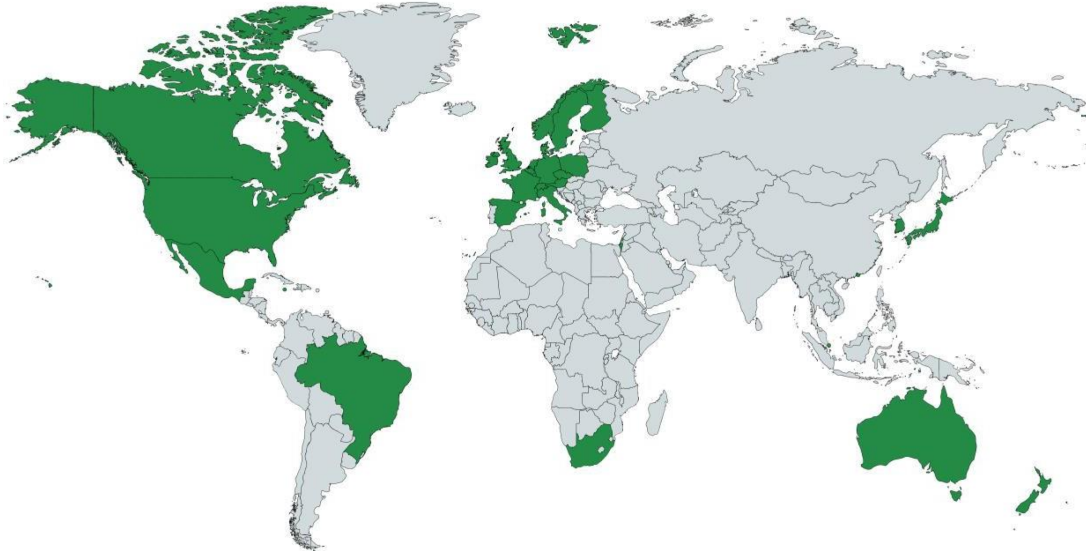
Management Type	Sum of Assets
DB Pension Plan	$913,891.45
DC Pension Plan	$268,495.99
Corporations and Governments	$490,861.63
Not-for-profits, Foundations & Endowments	$81,587.97
Other Institutional	$205,166.69
Retail - Affiliated	$2,061,977.46
Retail - Sub-advised	$316,185.32
Total	**$4,338,166.50**

Data excludes the big in-house/Canadian public pension funds such as CPP, Teachers etc. However, should an institution—such as a Big Six Bank or other—sub-advise on behalf of one or multiple of the Canadian public pension funds, those numbers would be included in the total.

Current Designated Stock Exchange (DSE) List Countries

Pooled Funds with less than 150 Unitholders (no Mutual Fund Trust Status)

Only Green Shaded Countries Accessible for RRSPs RRIFs DPSP, RESP or pension plans in pooled fund



Countries with which Canada has Tax Treaties & Tax Information Exchange Agreements