THE INVESTMENT FUNDS INSTITUTE OF CANADA
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Mr. John Luck
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Ms. Josee Allard
Canada Customs and Revenue Agency
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Dear Mr. Luck & Ms. Allard:

Re: Allocation of Capital Gains

We are writing further to our meeting earlier this year regarding the allocation of capital gains to persons who redeem units of a trust and the tax reporting of such allocated gains. We understood that both the Taxation Steering Committee (on behalf of the Investment Funds Institute of Canada (IFIC) and the fund industry) and the Canada Customs & Revenue Agency (CCRA) had undertaken to do certain things or to provide certain information following the meeting.

Specifically, the Committee had agreed to do the following:

1. Provide a summary of the July 2001 meeting with the Department of Finance to discuss "harmonization" of tax rules for investment funds.

2. Explain further the concept raised at the meeting regarding the interaction between the statutory capital gains refund mechanism (CGRM) and IFIC's proposed tax reporting method and how such method is consistent with the existing law.

3. Provide another example of the proposed allocation method and how such method does not cause any "tax leakage" to the government.

We understood that you had undertaken to discuss with the various "constituencies" within the government our fact situation and the requested tax reporting method for capital gains of a trust that are allocated out to persons who redeem units. In this regard, Mr. Luck indicated at the outset of the meeting that the CCRA wanted to understand the issue from the perspective of the industry and to understand the technical aspects of the allocation to redeemers methodology and the CGRM. We believe that our written document and the discussions at the meeting conveyed the practical issues faced by the industry in trying to adopt a tax allocation method that is now sanctioned by the Income Tax Act (ITA). We would appreciate a report from you regarding the response of the various government departments to our proposed tax reporting method.

We will now address the matters that we had undertaken to complete.

1. Summary of the meeting with the Department of Finance

Last summer, various Committee members met with the Department of Finance. The purposes of the meeting were to learn what types of changes the Department may be considering making to the rules governing the taxation of mutual funds and to outline the interests of the industry if such amendments were proposed. Representatives from the Department of Finance at the meeting were Brian Ernewein, Bill Holmes, Lawrence Purdy, Grant Nash and Patrick Boyle.

Much of the meeting was dedicated to answering questions put forward by Finance. The area of greatest concern for the industry from that meeting was the suggestion made by Finance that one solution to the problem of different tax rules for different investment structures was an amendment that would require a single structure going forward (most likely a trust). We maintained that both trusts and corporations should survive and argued that the implementation of a single structure would be awkward and costly. We also explained some of the reasons why an organization would select to structure a fund as a mutual fund corporation, which included eligibility for relief provided by various tax treaties on certain forms of income, limited liability and differences in corporate governance.

Finance was also interested in discussing how the CGRM could be improved. The disadvantages of the current model were presented and the benefits of adopting a mechanism similar to that utilized by segregated funds were put forward. The topic of switch fund corporations was also discussed briefly.

Based on the premise that both trusts and corporations should continue to exist, but differences in the taxation of these structures should be removed, we expressed an interest in the rules being amended to allow complete flow through treatment of all types

of income for corporations (a current element of the trust structure). The corporate structure is currently inefficient and can result in tax being paid at the fund level on certain sources of income. Conversely, industry members would also be in favour of incorporating elements of the corporate structure into the trust structure by extending the provisions of section 51 of the ITA to include mutual fund trusts. Finally, reasons were presented why industry participants would benefit by being able to convert existing mutual fund trusts to corporations (by amending section 132.2 of the ITA).

2. *Interaction of the CGRM and IFIC's proposal*

As discussed at the meeting, the current provisions of the ITA, specifically the CGRM, interact with and are consistent with our proposed tax reporting method for capital gains allocated to redeeming unitholders (i.e., effectively include such gains on the T5008 rather than the T3 slip). We undertook to elaborate upon that concept in support of our request.

The CGRM allows a mutual fund trust to reduce the amount of its realized capital gains that would otherwise be payable to unitholders and reported on T3 slips. The CGRM allows such gains to be retained in the fund and not included in a T3 slip because those persons who redeemed units in the year have already reflected them in their proceeds on redemption of units. The form for reporting these redemption transactions is the T5008. In other words, capital gains that would otherwise be reported on a T3 slip but for the CGRM now show up through a combination of the T5008 (as proceeds of disposition) and the voluntary self-assessment system (i.e., the investor reporting his or her gain on redemption on the T1 return).

The allocation to redeemers methodology that IFIC members propose to adopt attempts to mitigate the inefficiencies of the CGRM. The theory behind the CGRM (i.e. to reduce the gains at the fund level that must be included on a T3 slip by the amount of gains realized on the redemption of units during the year) does not bear out in practice because the formula for "capital gains redemptions" does not produce the desired result. For example, a fund with an overall accrued loss on its portfolio at year-end will not benefit from the CGRM even though at some time during the year there were investors who redeemed units and realized gains and the fund itself had net realized gains for the year. In this case, the fund would have to distribute all of its net realized capital gains for the year. Another situation would be a fund with an unrealized gain position at year-end that is lower than the aggregate amount of gains actually realized by investors who redeemed during the year. The allocation of gains to redeeming unitholders that IFIC members want to adopt would overcome the inefficiencies of the CGRM in these types of situations. The proposed methodology of allocating gains to redeemers has the same effect as the CGRM, and therefore, we submit that the same reporting method is appropriate. We are allocating gains to investors who redeem, rather than to persons who are unitholders at year-end (effectively what the CGRM does and the reporting in the latter case is through the T5008).

We have prepared an example (attached as Exhibit A) which assumes that two unitholders each invest $100 in a mutual fund at the beginning of the year. We will assume that the fund doubles in value to $400 by the end of the year. One unitholder redeems his investment of $200 for a gain of $100. To meet this redemption request, the fund sells a portion of its holdings for $200 realizing a gain of $100 inside the fund. Scenario one demonstrates the CGRM methodology. Scenario two demonstrates IFIC's proposed methodology in allocating capital gains to redeeming unitholders. Scenario three illustrates CCRA's proposed method for dealing with the redeemers' gains. As you can see by the attached exhibit, in all three scenarios the client reports gains of $100 on his or her T1 return, based on either the T5008 (in scenarios one and two) or based on the T3 (in scenario three.) Note that scenarios one and two both propose to include the $100 through the T5008 reporting method, while only scenario three reports the $100 on a T3.

3. No tax leakage – example

At our meeting, you indicated to us that you believe that our proposed reporting method may lead to potential tax leakage to the government. We believe this not to be the case. In fact, we do not understand the inner workings of the CCRA and the programs that are in place to check the T3 or T5008 filings by the entity preparing the form back to the individual returns. To the extent that you perceive discrepancies in T5008 reporting generally, they should be addressed independently of our submission.

To illustrate that no tax leakage exists, let's assume that a mutual fund had $300 million of capital gains arising from the disposition of securities during the year and various investors who redeemed out of that fund had $100 million of capital gains upon redemption. If, at year-end, the unrealized gain of this fund is either zero or is in fact, an unrealized loss, the capital gains refund formula will not allow any capital gains to be retained inside the fund. As a result, the fund will be forced to distribute the full $300 million to the investors who remain at year-end. This $300 million will partially appear on T3 slips for individual investors who hold their units in non-registered accounts. We understand that the CCRA currently has the ability to track a portion of the $300 million to the extent that it appears on individual T3 slips for non-registered investors.

With the proposed IFIC redeemers' gain methodology, the fund will be able to allocate $100 million of the fund's total capital gains realized on disposition of securities to unitholders that redeemed during the year. This amount would be reported through the T5008 mechanism. The remaining $200 million will be reported, to some extent as capital gains distributions, on various T3 slips issued to investors who hold their units in non-registered accounts.

You indicated that you are concerned that the $100 million that is reported through the T5008, as opposed to included on a T3, will potentially represent "tax leakage" in that the

CCRA will no longer be able to administer the collection of tax on the $100 million. We suggest, in fact, that this is not true. In the current reporting regime, the unitholders' gains (at the personal level) are already being reported through a T5008. In IFIC's proposed reporting methodology, nothing has changed. Instead of merely using the CGRM in an attempt to mitigate the double taxation of capital gains (i.e. once at the fund level and once at the unitholder level), IFIC is proposing to use the redeemers' gain method to reduce distributions payable by the fund. IFIC's proposed methodology uses the same T5008 reporting as before. The only difference that IFIC is trying to achieve is how the CGRM is being applied at the fund level. In fact, no change is being contemplated at the individual reporting level. We are just improving upon the CGRM. We refer you again to Exhibit A, where in scenario one (the current CGRM method) the $200 of proceeds is reported on the T5008, and similarly in scenario two (IFIC's proposed method of allocation of capital gains to redeeming unitholders), the same $200 of proceeds is reported on the T5008.

In the above example, the $100 million represents a reduction in the amount of distribution that the fund would otherwise have to make. Since the $100 million has not been distributed, no tax should be owing. This is precisely what IFIC's proposed methodology is trying to achieve. By eliminating the double taxation of the capital gains in the year (i.e. once in the hands of redeeming unitholders and again through the distribution to unitholders at year end), the entire system works more efficiently and Canadian investors in mutual funds avoid being unduly doubly taxed in the year. Therefore, we submit to you that it is *not* tax leakage but the avoidance of double taxation in the year that is the goal of IFIC.

We look forward to hearing from you and scheduling an early follow-up meeting, after you have an opportunity to review and consider the issues discussed herein. It is in the interest of all members of the Investment Funds Institute of Canada to work towards a favourable resolution to this issue before the end of this summer so that programming changes may be made at the back offices of fund companies and their administrators.

Yours truly,

"ORIGINAL SIGNED BY J. MOUNTAIN"

John Mountain
Vice President
Regulation

Attachment