THE INVESTMENT FUNDS INSTITUTE OF CANADA
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By Facsimile **(613) 992-4450**

Mr. Brian Ernewein
Director
Tax Legislation Division
Department of Finance
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Dear Brian:

Re: December 21, 2000 Draft Legislation

We are writing to provide comments on the draft legislation to amend the Income Tax Act (Canada) (the "ITA") released on December 21, 2000 (the "Draft Legislation") as it affects the investment funds industry. Unless otherwise noted, references to clauses herein are to clauses of the Draft Legislation and references to sections and components thereof are to the ITA as it is to be amended by the Draft Legislation.

Clause 13(5)(l)

Should the reference to "net gains" be a reference to "net capital gains"?

Clause 20(7)

Subclause 53(2)(h)(i.1)(B)(I) of the ITA is intended to prevent the reduction in the adjusted cost base of a trust unit under subparagraph 53(2)(h)(i.1) in respect of the non-taxable portion of a capital gain distributed to a unitholder when the taxable capital gain is designated in respect of the unitholder under subsection 104(21). Subclause 53(2)(h)(i.1)(B)(I) should be amended to read "that is equal to the amount designated by the trust under subsection 104(21) in respect of the taxpayer" since, under the 50% capital gains inclusion regime, the non-taxable portion of the capital gain is equal to the taxable portion.

<u>Clause 38</u>

While rules are clearly needed to give appropriate tax-deferred treatment for foreign spin-offs, we respectfully submit that the proposed rules are unworkable from a practical perspective. In brief, our concerns are as follows:

> Requiring the foreign corporation to provide information directly to the Minister is impractical, both in terms of the nature of certain information and the expected lack of responsiveness by those corporations. This condition would effectively deprive most Canadian taxpayers of the benefits of this provision.
>
> The time frame for compliance by the foreign corporation (six months) together with the uncertainty about the prospects of receiving this information make this provision of limited or no benefit to an investment fund. The amount and character of an investment fund's income for the year must be known by year-end.
>
> The phrase "widely held and actively traded" lacks precision and should be replaced.

Proposed paragraph 86.1(2)(e) provides that a foreign spin-off will not be an eligible distribution unless the particular corporation provides certain information listed in subparagraphs (i) to (vii) directly to the Minister.

The Canadian tax system is one of self-assessment and the requirement for what in many cases may be a minority Canadian shareholder to convince a foreign corporation to comply with the requirements in paragraph 86.1(2)(e) is unrealistic and impractical. The onus should be on the taxpayer to determine whether a particular spin-off would qualify as an eligible distribution and report it as a tax-deferred transaction or taxable transaction in the taxpayer's tax return based on that determination.

We expect that many Canadian taxpayers, especially those that hold shares as an investment (rather than Canadian employees of the foreign corporation or a Canadian subsidiary), would be unfairly deprived of the tax relief intended by section 86.1 due to the failure of foreign corporations to provide the required information to the CCRA. Foreign corporations would be highly unlikely to comply for various reasons. Firstly, they would generally have little or no knowledge of the existence of the Canadian requirements. Secondly, they may not have records of their shareholders indicating their residential status. There may also be restrictions on providing such information to third parties. Finally, the compliance costs may be quite high and the foreign corporation has no significant incentive to comply and incur such costs.

From a mutual fund trust's point of view, its income (including capital gains) must be distributed by its year end in order to avoid having the fund pay tax on such income

inside the fund. Mutual funds (and other flow-through entities) may not know how much income to distribute before the end of their taxation years, particularly where a foreign spin-off has occurred during the final six months of the fund's taxation year. The fund may not know by the time it has to make a distribution whether the foreign corporation will comply and provide the necessary information since it has six months to do so. Furthermore, T3 or T5 slips might have to be amended. This would be a major problem to mutual funds with hundreds of thousands of unitholders, and might require many T1 reassessments to be made by the CCRA. Finally, mutual fund trusts might have unintended returns of capital in the case of over-distributions where the foreign corporation is not expected to comply with the reporting requirement but subsequently does so. In that case, investors may be required to reduce the adjusted cost base of their units.

We believe that the particular foreign corporation is not the best source of the information required by paragraph 86.1(2)(e) and that whatever information it could provide would be insufficient. It would not be able to provide names and addresses of the vast majority of Canadian shareholders, since foreign shares are commonly held through Canadian or foreign custodians. In addition, it may not know whether shares held by Canadian custodians are held on behalf of residents of Canada as huge blocks of foreign shares are held by Canadian custodians on behalf of foreign holders. Moreover, since subparagraph 86.1(2)(d)(iv) requires the names and addresses of Canadian residents, it is not sufficient to provide a list of shareholders with Canadian addresses.

There may be alternative means for the CCRA to gather certain information it might need in connection with a foreign spin-off, such as the information circular provided to shareholders of the corporation, or from Canadian custodians.

In order to deal with the foregoing principal concerns, we submit that all qualifying spin-offs after 2000 (or after October 17, 2000) be treated as non-taxable in the first instance. The tax treatment should not be determined by action or lack of action on the part of a foreign corporation not subject to Canadian compliance requirements. Taxpayers should be able to make their own determination whether a spin-off was an eligible distribution or a prescribed distribution and file their tax return in the appropriate manner. Accordingly, we submit that paragraph 86.1(2)(e) of the draft amendments should be deleted.

The phrase "widely held and actively traded" common shares in subparagraphs 86.1(2)(c)(ii) and (d)(ii) is unclear, although we expect that there are legitimate policy reasons for requiring more than a stock exchange listing. We understand that some foreign corporations list their shares on the Irish Exchange, for example, although it is not expected that the shares will trade on that exchange. However, the use of the term "widely held and actively traded" could be interpreted to preclude the application of the rules to a situation where a corporation has a majority shareholder and the minority

shares are relatively thinly traded due to large minority discount. We also think that the rules ought to apply to depository receipts evidencing common shares of a corporation where the depository receipts are listed on a prescribed stock exchange, whether or not the common shares are also listed on a prescribed stock exchange. Reference is made to Regulation 4900(1)(p.1) in this regard.

Proposed paragraph 86.1(2)(f) provides that, except where Part XI applies to the taxpayer, the taxpayer must make an election in the taxpayer's tax return for the year in which the distribution occurred. It appears that the rules apply automatically to a taxpayer subject to Part XI of the ITA (including a registered investment) and there are circumstances where that may be inappropriate. For example, if the adjusted cost base of the original share is $100, the fair market value of the original share is $70 immediately before the spin-off and the fair market value of the spin-off share is $50, the application of subsection 86.1(3) results in the adjusted cost base of the original share being reduced to $28 and the cost of the spin-off share being $72. If section 86.1 had not applied, the adjusted cost base of the original share would still be $100 and the cost of the spin-off share would be $50. If the taxpayer then sells the original share, it ends up with foreign property with a cost amount of $72 under the proposed rules but would have had foreign property with a cost amount of $50 if the proposed rules did not apply.

<u>Clauses 77(1) and (2)</u>

We have a number of questions and concerns with respect to the proposed amendments to paragraph 131(1)(b) of the ITA.

It appears that a capital gains dividend received by a taxpayer "in respect of" capital gains realized by a mutual fund corporation from dispositions of property before February 28, 2000 will receive the benefit of the 50% inclusion rate if it is received by the taxpayer in a taxation year that did not (i) begin after February 27, 2000 and end before October 18, 2000, or (ii) include February 27, 2000. For example, a capital gains dividend paid to an individual in February 2001 by a mutual fund corporation that has a December 31 year end would be governed by subparagraph 131(1)(b)(v). On the other hand, a capital gains dividend received by a taxpayer in respect of capital gains realized by the mutual fund corporation from dispositions of property that occurred after February 27, 2000 and before October 18, 2000 (the "Interim Period"), will always be grossed-up by four-thirds if the taxpayer's taxation year begins after October 17, 2000. This result occurs because of the "open-ended" wording of subparagraph 131(1)(b)(iii). It is not clear to us why the two-thirds inclusion rate in respect of gains realized by the mutual fund corporation in the Interim Period continues indefinitely but the three-quarters inclusion rate in respect of gains realized before February 28, 2000 does not.

It is also not clear to us how a mutual fund corporation determines what capital gains a dividend is paid "in respect of" for these purposes. In principle, the inclusion rate for the shareholder should correspond to the inclusion rate that would apply at the corporate level to determine the amount of tax payable if no dividend were paid. Thus, any capital gains dividend paid by a mutual fund corporation for its taxation year that does not include February 27 or October 17, 2000 should be taxed at the 50% inclusion rate.

We seek clarification of the Department's intention regarding the T5 reporting responsibilities of a mutual fund corporation in light of proposed subsections 131(1.5) and (1.6). We also seek relief from these rules as they apply to a mutual fund corporation that pays a capital gains dividend in 2001 or later years that may be in respect of capital gains realized by the corporation in its 2000 taxation year. The appropriate tax treatment of a capital gains dividend covered by any of proposed subparagraphs 131(1)(b)(i) to (iv) will depend on the tax year-ends of the shareholders. For example, a capital gains dividend paid out of the corporation's gains that were realized in the Interim Period will either be grossed up by four-thirds by subparagraph 131(1)(b)(iii) or be included at its face amount under subparagraph 131(1)(b)(iv), depending upon the shareholder's taxation year of receipt. While most investors in mutual fund corporations are individuals, some shareholders are corporations and trusts which do not have December 31 year ends. The mutual fund corporation will not know these shareholders' year-ends. Subject to our comments below regarding this issue, would you confirm that the disclosure on the T5 slips is to be limited to a breakdown of the capital gains dividend among the three periods? In other words, we have assumed that it is the responsibility of the individual shareholder to determine which of subparagraphs 131(1)(b)(i) to (iv) apply.

We also understood that the transitional rules for the capital gains inclusion rate were, from a policy perspective, to apply only in 2000. However, if a mutual fund corporation has a December 31 year-end, a capital gains dividend paid in the first 60 days of 2001 could be caught by any of subparagraphs 131(1)(b)(i) to (iv) so that the prescribed form contemplated by subsection 131(1.5), which would be prepared for the 2001 tax year of shareholders, will have to have the breakdown of capital gains contemplated by proposed subsection 131(1.5). Also, if the two-thirds inclusion rate is to be continued for capital gains realized in the Interim Period as described above, mutual fund corporations must put in place computer systems to track these gains indefinitely. We question the need for our industry to bear the costs of system changes to track these amounts given the expected insignificant incremental revenues to the fisc. We also suspect that the vast majority of investors will not understand why there are three capital gains inclusion rate boxes on a T5 slip issued for the 2001 taxation year. Investors will likely be confused about whether they are to amend their 2000 tax returns to include these capital gains or apply the various inclusion rates from 2000 in preparing their 2001 tax returns. We seek a more practical solution to dealing with mutual fund corporations that pay a capital gains dividend in

2001 that is derived in part from capital gains realized in the three-quarters or two-thirds inclusion rate periods of 2000.

Clause 77(3)

Proposed clause 131(2)(a)(i)(B) provides for an additional amount of capital gains refund to a mutual fund corporation to reflect that tax may have been paid on the mutual fund corporation's taxed capital gains using an inclusion rate greater than 50%. The additional amount is to be the amount "that the Minister determines to be reasonable in the circumstances" having regard to certain enumerated factors.

It is submitted that the provision should provide for the additional capital gains refund to be the amount that is reasonable in the circumstances, having regard to the same factors, and not the amount that the Minister determines to be reasonable in the circumstances. The mutual fund corporation should determine the additional amount having regard to the enumerated factors. If the Minister disagrees with the mutual fund's calculation, the Minister can reassess the mutual fund corporation. In those circumstances, the issue that would be in dispute in an objection (or before the courts if an appeal is taken) is the amount that is reasonable in the circumstances, rather than what the Minister considers to be reasonable in the circumstances.

Clause 78(1)

We have the same comment with respect to proposed clause 132(1)(a)(i)(B) as with proposed 131(2)(a)(i)(B).

We understand that legislation to extend the daily proration of capital gains inclusion rates to segregated funds as contemplated by the October 18, 2000 Economic Statement will be included in the Bill tabled in Parliament.

Members of our Tax Steering Committee would be pleased to discuss our comments with you.

Yours very truly,

"ORIGINAL SIGNED BY J. MOUNTAIN"

John Mountain
Vice President, Regulation