THE INVESTMENT FUNDS INSTITUTE OF CANADA
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May 5, 2000

Mr. Karl Littler
Executive Assistant
Secretary of State, International Financial Institutions
House of Commons
Room 426-N, Centre Block
Ottawa, Ontario
K1A 0A6

Dear Mr. Littler:

Re: Draft Tax Legislation - Non-Resident Investment Funds that Engage Canadian Service Providers

We are writing, further to our meeting with you on April 12, 2000, to summarize the outstanding issues on this matter, and proposals that we have discussed with officials of the Department of Finance for resolving these issues. We understand that the Department will recommend to the Minister of Finance that those proposals contained in this letter which are acceptable to the Department [1] be added to the provisions of draft section 115.2 of the *Income Tax Act* (Canada)[2].

I would like to take this opportunity again to thank you for taking the time to meet with us and for taking into account our (and our Members') submissions to you on this very important matter over the past several months. We appreciate the Minister's goal, articulated in his February, 1999 Budget, of developing Canadian tax rules that will assist in making the Canadian investment funds industry internationally competitive. We share this goal and the proposals below are intended only to assist in achieving this goal.

In our letter to you of January 7, 2000, we outlined proposed amendments to draft section 115.2 of the *Income Tax Act* (Canada) as set out in the Notice of Ways and Means Motion[3]. The balance of this letter summarizes the status of our proposed amendments as we understand it from our meeting of April

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[1] We understand that the Department has accepted a number of our proposals, including, for example, the proposal relating to custody and administration services.

[2] Draft section 115.2 is currently before the House of Commons in Bill C-25 (which received first reading in the House on February 16, 2000) (the "Bill").

[3] This motion was tabled in the House of Commons on December 7, 1999. The text of draft section 115.2 is not materially different in the Motion and the Bill.

12, 2000 and our telephone conversations with you and your officials since then. Points 1 to 5 below relate to Canadian service providers who provide services other than custody and fund administration services to a non-resident investment fund. Point 6 deals with Canadian service providers who only provide custody and fund administration services to the non-resident investment fund.

1. Definition of Qualified Non-Resident Investment Fund (maximum 20% investor requirement)

The Bill requires, through the definition of "qualified non-resident fund" that, generally, no person or partnership hold an interest in the non-resident fund, the fair market value of which exceeds 20% of the total value of all interests in the non-resident fund. We understand from your officials that this requirement was intended to ensure that investors in the non-resident fund could be considered to be "passive" investors, rather than as investors who controlled or directed the decision-making of the fund or its service providers.

Our January 7, 2000 letter proposed to eliminate this requirement. As we have advised, we strongly believe that the inclusion of this requirement will seriously impair the ability of Canadians to achieve the stated objective of the provision, which is creation of an internationally competitive investment funds industry[4].

In lieu of this requirement, we proposed in our January 7, 2000 letter that where the Canadian service provider provides services other than solely investment administration or custody services, generally no investor in the fund could be related to the Canadian service provider. This proposal was in the form of new subparagraph 115.2(2)(c)(iii), which we proposed be added to the Bill.

We note that neither the 20% requirement, nor our proposal in lieu of this requirement, is contained in either domestic US or UK tax laws applicable to non-resident funds that retain service providers located in those jurisdictions[5]. We believe that our proposal is more onerous than any investor-related

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[4] Our concerns with this provision were detailed in our letter of December 9, 1999. In essence, we are concerned that this requirement exposes investors to risk of Canadian tax liability through the actions (for example, redemptions of interest) of another investor, which are completely beyond their control, and when their original decision to invest was made based on an assumption that they would be able to rely on the safeguard created by proposed section 115.2. Further, we are concerned that Canadian service providers will be effectively prohibited by draft section 115.2 from accepting large institutional investors as clients, because of the likelihood that any such client would, until the track record of the non-resident fund was well-established, hold in excess of 20% of the total value of all interests in the non-resident fund. Finally, we note that most funds are provided with seed capital by parties related to the service provider, and that until investors are found to replace the provider of seed capital, that party typically will own significantly more than 20% of the value of investments in the non-resident fund. The current draft of section 115.2 effectively prohibits the seeding of non-resident funds by these parties, and thus, inevitably, substantially eliminates the ability of a new non-resident fund to utilize Canadian service providers.

[5] Indeed, those laws either contain no requirements of any kind relating to the number or size of investors in the non-resident fund (as in the case of US laws) or simply require that investors in the fund who are affiliated with the local service provider not hold more than a 20% interest in the non-resident fund (as in the case of UK laws).

requirements imposed under corresponding US or UK domestic laws. Nonetheless, our industry has indicated that it can abide by such a proposal.

In addition, in order to achieve a resolution of this issue which is acceptable to the Department of Finance, members of our industry are now also prepared to abide by an additional requirement to the effect generally that no one investor either alone, or together with related persons, owns more than 50% of the voting securities of the non-resident fund. We would propose that this additional requirement be added to our proposed new subparagraph 115.2(2)(c)(iii) contained in our January 7 letter, and have attached as Appendix I a draft revision to subparagraph 115.2(2)(c)(iii).

With this additional requirement, we submit that investors in the non-resident fund should be viewed by the Department of Finance as passive investors who do not in any way control the decision-making of the non-resident fund or any Canadian service provider to the fund.

As noted (both above and in our letters, meetings and phone calls with you), our industry simply cannot effectively compete internationally where Canadian domestic tax laws prohibit any one investor from holding more than a 20% interest in a non-resident fund. We believe that we have made significant efforts, in our January 7, 2000 proposal and this additional proposal, to accommodate the concerns of the Department on this issue and we trust that the Department will view these proposals favourably.

2. Qualified Investments

Our January 7, 2000 letter proposed that the definition of “qualified investment” contained in the Bill be amended to conform with the definition thereof contained in the September 10, 1999 draft legislation relating to section 115.2. We understand that the Department of Finance does not wish to make this amendment, but rather would prefer to ensure that the definition of qualified investment contained in the Bill be amended by adding items to the definition to ensure that the definition is comprehensive.

As we have previously advised you, the objective of our industry is simply to ensure that this definition is comprehensive (and will remain comprehensive as investment strategies and techniques evolve over time) in that it covers investments and investment instruments which are used by prudent investment funds from time to time. We understand that the Department shares this objective.

We understand from our Members that the definition of qualified investment contained in the Bill will be acceptable for this purpose if it is amended to include, more clearly, index-linked derivatives (including options, futures, forwards and swaps) and derivatives relating to interest rates[6]. We understand that the intention of the Department of Finance was not to exclude these items and, therefore, that these proposed amendments should be acceptable to the Department of Finance.

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[6] We are concerned that derivatives relating to interest rates are not currently included because such derivatives may not be viewed as being in respect of “indebtedness”.

3. Sale of the Non-Resident Fund to Canadians

We understand that the proposal in our January 7, 2000 letter to permit non-resident funds to be offered to Canadian tax-exempt investors who are subject to the foreign property investment limits is not acceptable to the Department of Finance.

In order to achieve resolution of the remaining issues regarding this matter, our industry is prepared to forego this proposal as requested by the Department.

4. Definition of Designated Services - Marketing Services

As indicated below, we understand that the Department of Finance has accepted the proposal contained in our January 7, 2000 letter to the effect that fund administration and custodial services alone be described in a new paragraph (d) to be contained in this definition. Accordingly, paragraph (c) of this definition would now only apply to brokerage, distribution, communication and marketing services[7].

5. Arm's Length/Investment Turnover Requirements

We understand that the Department of Finance accepts the proposal contained in our January 7, 2000 letter relating to these requirements and, accordingly, that a new subparagraph (iii) will be added to paragraph 115.2(2)(c) contained in the Bill along the lines set out in our letter. The Department indicated that it will require that this proposal be subject to a commercially reasonable transfer pricing requirement. As we advised you in our April 12, 2000 meeting, such a requirement, in principle, is acceptable to our industry.

6. Fund Administration and Custody Services

You indicated in our April 12, 2000 meeting, and officials of the Department of Finance have subsequently confirmed by telephone, that the Department agrees in principle with the proposal contained in our January 7, 2000 letter to the effect that a non-resident fund which retains a Canadian service provider solely for the purpose of providing fund administration and custody services will not be considered to carry on business in Canada provided that the requirements in paragraphs 115.2(2)(a) and (b) contained in the Bill are met. To this end, we understand that officials of the Department have agreed that such services be described in a new paragraph (d) of the definition of "designated services" that will be added to the Bill and that new subparagraph 115.2(c)(iv) will be added to the Bill to refer to a Canadian service provider which does not provide any services to the non-resident fund except those referred to in such paragraph (d).

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[7] As stated in point 3 above, our industry accepts that the non-resident fund not be sold to Canadians and, accordingly, no "designated services", including those referred to in amended paragraph (c) of this definition, will pertain to Canadian investors by virtue of the requirements of subsection 115.2(2) contained in the Bill.

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We are very grateful for the opportunity to have worked with you and others in the Department of Finance to develop proposals which are workable for the Department and our industry, and which assist our industry to become internationally competitive. We strongly believe that the proposals contained in this letter achieve these goals. Please call me at your earliest convenience if you require any further information, or if you have any concerns that any of these proposals may not be acceptable to the Department.

Yours very truly,

"ORIGINAL SIGNED BY J. MOUNTAIN"

John Mountain
Vice President, Regulation

encl.

cc. Len Farber
Brian Ernewein
Jim Green

APPENDIX I

Proposed Language for Subsection 115.2(2)(c)(iii)

s.215.2(2)

(c) …

(iii) no person or partnership (other than a qualified non-resident fund) who beneficially owns an interest in the fund (other than a non-participating interest or an interest that is necessary to satisfy any seed capital requirements applicable to the fund) is related to the Canadian service provider <u>or holds, either alone or together with related persons, more than 50% of the securities of the fund having full voting rights in all circumstances</u>; or

(iv) ….

(Changes to language contained in the draft attached to our submission of January 7, 2000 are underscored)