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BY MAIL AND FAX (1-613-992-8320)

September 24, 2007

The Honourable Jim Flaherty, P.C.
Minister of Finance
House of Commons
55 Wellington Street
Ottawa, ON K1A 06A

Dear Minister:

Re: Eliminating Double Taxation of Income of Mutual Fund Corporations

I am writing to you to request that you give consideration to allowing mutual fund corporations to be given similar tax treatment as mutual fund trusts are permitted.

A mutual fund can be organized in Canada either as a corporation or as a trust. There are currently in excess of 200 mutual funds in Canada organized as corporations. Most of these funds have been established in recent years.[1] However, there are two significant tax problems faced by these corporations:

(a) Interest income and foreign source dividends earned by a mutual fund corporation cannot be flowed out to the shareholders without a level of double taxation.

(b) To the extent that foreign source income and foreign source capital gains have been subject to foreign income tax, the shareholders are not able to obtain a foreign tax credit. This results in additional double taxation.

These double taxation results are obviously inappropriate,[2] particularly in light of recent tax policy developments:

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1 Among other things, the recent growth in mutual funds organized in corporate form reflects the ability of a shareholder of a mutual fund corporation to change his or her exposure from one investment mandate (e.g., Canadian equities) to another investment mandate (e.g., global equities) on a tax-deferred rollover basis. This result is consistent with the policy of the government put forward during the last election. The Conservative Party platform, "Stand Up for Opportunity" proposed that capital gains realized by individuals upon the disposition of real and financial assets would be exempt from taxation if the proceeds were reinvested within a six-month period. This is the result where a shareholder of a mutual fund corporation "switches" from one class of shares of a mutual fund corporation to another class of shares of the same mutual fund corporation.

2 In the context of mutual funds where many investors have long investment horizons, it is important to recognize that even a modest reduction in an investor's annual rate of return due to double taxation will result in a significant reduction in the investor's compound rate of return.

(a) The various tax rate changes in the last two years have had two tax policy objectives:

(i) The dividend tax credit changes (including the introduction of the "eligible dividend" concept) are designed to eliminate the double taxation from investing in Canadian public companies. Unfortunately, the changes did not eliminate the double taxation which occurs when a publicly offered mutual fund corporation earns revenue taxable as ordinary income (e.g., domestic or foreign source interest income and foreign source dividends). This is because the general rate reduction accorded to public companies excluded mutual fund corporations.

(ii) The income trust changes enacted in Bill C-52 are designed to promote a level playing field between Canadian public companies and income trusts. The policy of a level playing field between different forms of business and investment entities should obviously also be applied so that mutual fund corporations are not disadvantaged relative to mutual fund trusts.[3]

(b) The removal of the foreign property limit in 2005 is intended to enable Canadians to hold increased volumes of foreign securities in order to better diversify their portfolios, thereby increasing their returns to better meet their retirement goals. However, where Canadians use mutual fund corporations to achieve this result, they are penalized in two ways:

(i) As noted above, foreign source interest income and foreign source dividends earned by a mutual fund corporation are subject to a level of double taxation.

(ii) As also noted above, to the extent that foreign source income and foreign source capital gains have been subject to foreign non-resident withholding tax, the shareholders are not able to obtain a foreign tax credit, thereby resulting in additional double taxation.

The Appendix to this letter contains a more detailed discussion and analysis of the foregoing issues. We would be pleased at either your request or your officials to prepare comprehensive draft legislative language to address these issues.

I would be grateful if we could meet with you and your officials at a convenient time to discuss these issues in more detail.

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[3] Mutual fund trusts are, for all practical purposes, perfect flow-through vehicles for income tax purposes. Where a mutual fund trust pays out its income and capital gains, only the unitholders pay tax on such income. In addition, to the extent that such amounts have been subject to foreign non-resident withholding income tax, the unitholders are generally entitled to a foreign tax credit. These results generally reflect tax policy decisions made in 1972.

Thank you for your consideration of our concerns.

Sincerely,

THE INVESTMENT FUNDS INSTITUTE OF CANADA

Joanne DeLaurentiis
President & CEO

Appendix

Eliminating Double Taxation of Income of Mutual Fund Corporations ("MFCs")

1. Background

The *Income Tax Act* (Canada) provides for the flowthrough by mutual fund trusts and mutual fund corporations to investors of dividends from taxable Canadian corporations and capital gains. While the mechanisms to accomplish the flowthrough are different for each, the end result is the same. Amounts paid to investors retain their nature and related tax preferences and are not subject to fund-level tax.

Mutual fund trusts may designate amounts paid as taxable capital gains under subsection 104(21) and Canadian dividends under subsection 104(19) and deduct the designated amounts from the funds taxable income. Mutual fund corporations may elect that a dividend it pays be treated as a capital gains dividend under subsection 131(1) with the result that the corporation will not pay tax on its capital gains as they are "flowed out" to its shareholders. Mutual fund corporations, however, are taxed on Canadian dividends as if the corporation were a Canadian controlled private corporation (CCPC). The fund is subject to Part IV tax on the dividends and this tax is refundable under subsection 131(5) when the fund itself pays a dividend to investors. In this way, dividends flow through the corporate fund without any tax at the fund level, and retain their nature as dividends eligible for the dividend tax credit.

While mutual fund trusts and mutual fund corporations have equivalent treatment with respect to capital gains and Canadian dividends, they do not have equivalent treatment with respect to interest, foreign investment income or other investment income.

Mutual fund trusts may designate foreign source investment income and its associated foreign non-business-income tax credit under subsections 104(22) to 104(22.4). These flow through to investors without any fund-level tax. Interest and other investment income are not designated separately, but are simply treated as "other income" and flowed out to investors without any fund-level tax.

In contrast, foreign investment income, interest, and any other investment income do not flow through a mutual fund corporation. They are first taxed in the corporation, at the full general corporate tax rate. While a mutual fund corporation has access to the Part IV refundable tax in respect of Canadian dividends, it is denied access to the Part I refundable tax in respect of its other investment income. It is therefore taxed on foreign and other investment income at rates equivalent to those paid by public corporations. The net amount of investment income after tax may be paid out to investors as a dividend that is eligible for the dividend tax credit or may be retained in the fund. The investor obtains some tax relief, but does not recover all of the taxes paid at the fund level.

The net result is that there is double taxation to the investor from earning any type of investment income, other than dividends from taxable Canadian corporations or capital gains, through a mutual fund corporation. The mutual fund industry usually deals with this by restricting the securities held by a mutual fund corporation, so that significant

amounts of these types of investment income are not earned by the fund. This reduces the tax cost, but also limits the flexibility of the fund to invest in fixed-income or foreign securities and offer a wide range of investment opportunities to investors.

2. Purpose and Policy

The purpose of the proposed recommendations is permit the launching of new classes of funds within an existing, multi-class MFC, to give investors a broader choice of fixed income and global investments with which to better diversify their portfolios, enhancing their returns and enabling them to better save for their retirement.

This purpose is equally shared by the government, as reflected in the following recent legislative amendment and policy announcements:

- Removing the foreign property limit of 30% to permit registered plans greater access to global capital markets, thereby increasing the rates of return Canadians can earn on their savings (February 2005 federal budget).
- Promoting the concept of capital gains deferral when the proceeds of disposition are reinvested within six month – a goal which is perfectly accomplished when an investors switches on a tax-deferred basis from one class of an MFC to another (January 2006 Conservative election platform).
- Proposed elimination of withholding tax on interest income between Canada and the U.S., permitting Canadian funds to invest globally without this additional cost (March 2007 federal budget).

As a result, we specifically propose two sets of changes: new provisions to flow ordinary income and foreign source income through MFCs and a reduction in the corporate tax rate applicable to MFCs so that it is the same as the tax rate applicable to public corporations.

3. Flow Through of Investment Income

In order to obtain the desired flow-through treatment for ordinary investment income earned by a MFC, the following amendments to the Act are required:

- A provision permitting a MFC a deduction in computing income equal to the amount of net investment income that would otherwise be subject to Part I tax in the MFC.
- A provision that treats a payment or distribution to a shareholder by a MFC out of its net investment income as "ordinary" income from property, similar to a mutual fund trust, notwithstanding its legal character as a dividend or return of capital.

- Flow-through of the characterization of foreign source income, including underlying foreign non-resident withholding taxes paid, similar to a mutual fund trust.

- Ability to make an "over-distribution" election, similar to 132.11(6) where the amount included in the shareholders' income for a particular year exceeds the net investment income of the MFC.

4. Reduction of General Corporate Tax Rate for MFCs

To the extent that investment income of a MFC is not flowed out to the investors, we believe that it should at least receive the integration treatment which is now generally accorded to income earned by public corporations in Canada. Currently, all corporations (including mutual fund corporations) are subject to a federal corporate tax rate of 28% (excluding surtax). However, public corporations (but not mutual fund corporations) receive a "general rate reduction" so that their effective federal corporate tax rate is 21% for 2007, 20.5% for 2008, 20% for 2009, 19% for 2010, and 18.5% for 2011 (other than on certain income, such as income earned by a Canadian controlled private corporation that is subject to the small business deduction or that is "aggregate investment income"). The net result of the foregoing is to create a significant inequity between MFCs and other public corporations with respect to investment income paid out as a dividends to investors.

Canadian resident individuals receive a federal dividend tax credit of 11/18 of the amount included in income under subparagraph 82(1)(b)(ii), which requires individuals to include 45% of "eligible dividends" in computing income of the taxpayer. The enhanced gross-up and dividend tax credit for "eligible dividends" was enacted to minimize the impact of double tax where Canadian resident individuals invest in taxable Canadian corporations. However, such enhancement was based on a corporation that is subject to the general rate reduction. Therefore, there is still an element of double tax where Canadian resident individuals invest in a mutual fund corporation. The following table summarizes such inequity, assuming 2010 tax rates:

	Non-mutual fund public corporation	**Mutual fund corporation**
Income of corporation	$1,000	$1,000
Federal corporate tax rate	19%	28%
Federal tax	$190	$280
Net after-tax income paid as eligible dividend	$810	$720
Gross-up on eligible dividend (@ 45%)	$365	$324
Taxable income of individual	$1,175	$1,044
Federal individual tax rate (assume highest marginal tax rate)	29%	29%
Federal tax	$341	$303
Federal dividend tax credit	($223)	($198)
Net federal income tax	$118	$105
Total tax	$308	$385

The total tax paid in respect of income earned by a public corporation (but not a mutual fund corporation) is approximately 31%; whereas the total tax paid in respect of income earned by a mutual fund corporation is approximately 39%. In order to eliminate this significant inequity, we propose that income (excluding taxable capital gains) of a mutual fund corporation be subject to the same general rate reduction that is available to other public Canadian corporations.