THE INVESTMENT FUNDS INSTITUTE OF CANADA
L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA
151 YONGE ST., 5TH FLOOR, TORONTO, ONTARIO, M5C 2W7 TEL 416 363-2158 FAX 416 861-9937

August 13, 2003

Mr. Brian Ernewein
Director
Finance Canada
Tax Legislation Division
140 O'Connor Street
Ottawa, ON K1A 0G5

Dear Mr. Ernewein:

Re: Foreign Investment Entities

We are writing to request that the definition of "exempt interest" in subsection 94.1(1) of the *Income Tax Act* (Canada) (the "ITA"), as it is proposed to be enacted by the October 11, 2002 Notice of Ways and Means Motion, be amended to take into account our submissions made below. As set forth below, the proposed definition in its current form imposes an undue administrative burden on our industry and on CCRA from an audit perspective.

Background

Our organization represents approximately 96% of the "conventional" mutual funds in Canada that offer their securities to the public by way of a simplified prospectus and annual information form and are subject to the requirements of the Canadian Securities Administrators, including National Instrument 81-102 ("NI81-102"). Section 2.4 of NI81-102 imposes certain restrictions on the holdings by a mutual fund of "illiquid investments" which may be summarized as follows:

1. A mutual fund may not purchase an illiquid asset if, immediately after the purchase, more than 10% of the net assets of the mutual fund, taken at market value at the time of the purchase, would consist of illiquid assets.

2. A mutual fund may not have invested, for a period of 90 days or more, more than 15% of its net assets, taken at market value, in illiquid assets.

3. If more than 15% of the net assets of the mutual fund, taken at market value, are illiquid assets, the mutual fund must take commercially reasonable steps to reduce the percentage of its net assets made up of illiquid assets to 15% or less.

An “illiquid asset” is defined to mean:

1. An asset that cannot be readily disposed of through market facilities on which public quotations in common use are widely available at an amount that at least approximates the value at which the asset is valued in calculating net asset value per security of the mutual fund; or

2. A “restricted security” (i.e., one where the resale of which is restricted or limited by a representation, undertaking or agreement by the mutual fund or its predecessor in title, or by law), the resale of which is prohibited by representation, undertaking or agreement by the mutual fund or by the predecessor in title of the mutual fund.

By reason of the foregoing requirements, as a practical matter all or substantially all of the portfolio securities of each such conventional mutual fund will be securities that are actively traded on a stock exchange and which, even if they were participating interests in “foreign investment entities” (“FIEs”), *should* be “exempt interests”, but may not be under the proposed definition.

Submission

We expect that the proposed amendments to the ITA relating to FIEs have the greatest potential to affect those mutual funds that have mandates to invest globally, in emerging markets, in specific developing regions (eg. the Far East and Latin America), or in specific less developed countries. Such mutual funds commonly hold the securities of over 100 issuers; some may hold the securities of more than 500 different issuers. Each security of a foreign issuer must be examined individually in order to determine whether it is a participating interest in an FIE and whether it is an exempt interest. As a practical matter, the analysis will focus on whether an interest, if it were a participating interest in an FIE, would be an exempt interest.

The proposed definition of “exempt interest” is too restrictive and therefore will result in undue compliance burdens for these mutual funds and ultimately for the CCRA.

With respect to the requirements in subparagraph (i) of paragraph (e) of the definition, the list of prescribed stock exchanges in Regulation 3201 is outdated (a number of exchanges no longer exist) and not sufficiently comprehensive. Attached is what we believe to be a reasonably comprehensive list of the world’s stock exchanges; check marks denote those referred to in Regulation 3201. In addition, it is not clear to us that the policy considerations relating to prescribing stock exchanges for particular purposes (eg. qualified investments for RRSPs and other tax-deferred plans, prohibited investments for pension plans etc.) are necessarily applicable to the FIE rules, especially since the definition of “exempt interest” also incorporates the “widely held and actively traded” test. Subject to the comments relating to a possible alternative approach below, it would seem possible and desirable to have a separate list of prescribed stock exchanges for the purposes of the FIE rules.

As a secondary matter, we also submit that the requirements in subparagraph (ii) of paragraph (e) of the definition of “exempt interest” that the FIE be governed by and resident in a particular country with which Canada has entered into a tax treaty should be expanded to include countries with which Canada has entered into negotiations relating to a comprehensive tax treaty, subject to the ability to designate otherwise in the case of particular countries. We assume that one of the policy reasons for the tax treaty requirement is that Canada’s treaty partner imposes a comprehensive tax on entities resident in that country. Since we assume that Canada would not generally enter into treaty negotiations with a jurisdiction that did not impose such a comprehensive tax, we do not see any basis in the context of the FIE rules for distinguishing between those countries with which Canada has concluded a tax treaty and those countries with which Canada is prepared to negotiate a tax treaty. Subject to the comments relating to a possible alternative approach below, we acknowledge that if our submission were accepted, the definition of “exempt interest” would have to include a “hypothetical” test of residence, eg., that the relevant FIE would be resident in the country with which Canada has entered into treaty negotiations determined as if, for example, the concluded treaty defined residence in the same way as in the OECD Model Convention.

We believe that an alternative approach to that contained in subparagraphs (i) and (ii) of paragraph (e) of the definition of “exempt interest” that is worthy of consideration would be for the Regulations to contain a list of prescribed countries in which a foreign investment entity would have to be resident in order for a participating interest therein to be an “exempt interest” if the widely held and actively traded requirements were also met. The list of countries would include those with stock exchanges that are currently prescribed, treaty countries, countries with which Canada has entered into treaty negotiations and any other country that, from a tax policy perspective ought to be prescribed (i.e., because it imposes a comprehensive tax on entities resident in that country).

We respectfully submit that the requested amendments to the definition of “exempt interest” are consistent with the relevant tax policy. Our industry is committed to complying with the proposed amendments to the ITA relating to FIEs and non-resident trusts. However, from our industry’s perspective, if the amendments requested in this letter were made, its compliance burden would be significantly reduced without compromising the relevant tax policy.

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

Yours truly,

ORIGINAL SIGNED BY JOHN MOUNTAIN

John Mountain
Vice President
Regulation