IFIC
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

December 9, 1999

BY COURIER

The Honourable Paul Martin, M.P.
Minister of Finance
Government of Canada
L'Esplanade Laurier
140 O'Connor Street
Ottawa, ON K1A 0G5

Dear Minister:

Re: Proposed Section 115.2 of the *Income Tax Act* (Canada) - Non-Resident Investment Funds that Engage Canadian Service Providers

We are writing to draw your attention to a serious issue facing the Canadian investment service industry.

As is evident from the 1999 Federal Budget, the corresponding draft legislation released on September 10, 1999 and the Notice of Ways and Means Motion tabled on December 7, 1999 (the "December 7 Draft Legislation"), the federal government has appreciated the concern of Canadian investment service providers who provide their services to foreign funds that if a foreign fund engages their services, the foreign fund may become subject to tax in Canada. This potential for Canadian taxation was a serious impediment to the development of the Canadian investment service industry and the federal government addressed this issue by introducing proposed section 115.2 of the *Income Tax Act* (Canada).

Although the purpose of these proposed rules may be to encourage the development and expansion of the Canadian investment service industry, unfortunately, the rules as they are currently drafted, do not accomplish this goal. This continues to be the case in respect of the version of these rules contained in the December 7 Draft Legislation. The following is a brief overview of the reasons why proposed section 115.2 does not help our industry.

The 20% Requirement

Proposed Rule

The proposed rules offer relief only to "qualified non-resident investment funds." To be "qualified," no more than 20% of the total value of any fund may be in the hands of one investor, unless that investor is itself a qualified non-resident investment fund.

Issues

The nature of the offshore investment market is such that the proposed 20% requirement is unlikely to be satisfied in most cases for the following reasons:

- the offshore investment fund market involves very large, sophisticated investors such as institutional investors, substantial pension funds and high net worth individuals, and any one of these types of investors commonly exceed this 20% limit because of the large size of their investment (we note that the genesis of this requirement is the Canadian mutual fund tax rules which are geared to retail investors; this requirement appears inappropriate to "transport" to the sophisticated investor offshore fund market);

- many non-resident funds are specialty funds that have specific investment objectives or trading strategies that appeal to narrow groups of very large investors and, accordingly, the number of individual investors in a particular non-resident fund can be quite small;

- many non-resident funds would not meet this requirement in the start-up phase of the fund;

- the minimum investment requirements for many non-resident funds are substantial and, as a result, there are few potential investors in such funds;

- the non-resident fund market is volatile and investors frequently move from one fund to other; while this movement is beyond a fund's control, it could result in the fund failing to satisfy the 20% requirement; and

- a minor deviation from the 20% requirement, for even a short period of time, would cause a fund to lose the benefit of the proposed new rule.

The Arm's Length Requirement

Proposed Rule

The proposed rules require that Canadian investment service providers deal at arm's length with both the non-resident fund and the non-resident fund's promoter.

Issues

The arm's length requirement fails to achieve the stated goal of the proposed rules, namely, ensuring that Canadian tax rules permit the Canadian investment service industry to compete effectively in the international market, for the following reasons:

- the international investment service business is highly competitive and it is virtually impossible for Canadian investment service providers to offer services effectively in the international arena if they are prevented from offering services to non-resident funds with whom they are affiliated;

- by preventing non-resident funds from employing affiliated Canadian investment service providers, Canadian investment service providers are being denied an opportunity to showcase their expertise to the global market and develop international clients; and

- the arm's length requirement results in a decreased use of Canadian service providers by offshore funds thereby directing highly skilled jobs and revenue away from Canada.

The Turnover Requirement

Proposed Rule

As an alternative to the arm's length test, the proposed rules indicate that it would be acceptable for a Canadian investment service provider to have a non-arm's length relationship with a non-resident fund or non-resident fund's promoter provided the turnover of the non-resident fund's portfolio is less than three times per taxation year.

Issues

The nature of the non-resident investment market is such that the turnover requirement would not be satisfied by many non-resident funds because:

- many non-resident funds make investments which are very sensitive to interest rate changes, economic changes and political changes such as currency denominated investments and various debt investments, which by their very nature, may require sudden turnover;

- market conditions may require a fund to quickly liquidate certain types of investments; and

- a minor deviation from the turnover requirement would cause a fund to lose the benefit of this provision.

The No Canadian Investor Requirement

Proposed Rule

The proposed rules prohibit a non-resident fund from marketing and selling interests in the fund to Canadian residents.

Issues

This proposed requirement prohibits all Canadian investors, including pension funds, from investing in non-resident funds. This requirement is harmful to Canadian pension plans and to Canadians for the following reasons:

- pension plans maximize their investment returns by investing in a variety of investments with diverse investment objectives, styles and strategies; the proposed requirement limits the access of pension plans to foreign markets thereby reducing their opportunity to invest in the global market and maximize their investment returns; and

- the amount of foreign property a pension plan may hold is already limited by the foreign property rules and thus the proposed requirement is unnecessary.

Qualified Investment Requirement

Proposed Rule

Unfortunately, the December 7 Draft Legislation imposes an additional burden on non-resident funds that wish to retain Canadian service providers. In effect, this legislation requires such funds to restrict their investment portfolio to "qualified investments" as defined in such legislation.

Issues

This qualified investment requirement is not practical because:

- it will further discourage non-resident funds from retaining Canadian service providers; and

- non-resident investment funds will not comply with Canadian investment restrictions when they can retain service providers in many other countries, including the United States, which do not impose any such restrictions.

We have not yet had an opportunity to assess the December 7 Draft Legislation fully. We will contact you if we identify any further significant issues with this legislation.

Relief Requested

To address these serious issues, we believe that proposed section 115.2 should be amended as follows:

- the 20% requirement should be deleted or increased substantially;
- the arm's length requirement should be deleted;
- the turnover requirement should be deleted;
- the prohibition against Canadian investors investing in non-resident funds should be amended to allow certain Canadian investors, such as pension plans, to invest in such funds; and
- the qualified investment requirement should either be eliminated or amended to conform to the September 10, 1999 version of this requirement.

We would be pleased to meet with you to discuss these issues further.

Yours very truly,

THE INVESTMENT FUNDS INSTITUTE OF CANADA

"ORIGINAL SIGNED BY T. HOCKIN"

Honourable Thomas A. Hockin
President and Chief Executive Officer