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

August 4, 1999

Mr. Simon Thompson
Tax Policy Branch
Department of Finance
140 O'Connor Street
17th Floor, East Tower
Ottawa, Ontario K1A 0G5

Dear Mr. Thompson:

Re: Superficial and Stop Loss Rules Relating to Mutual Funds

I am writing on behalf of The Investment Funds Institute of Canada ("IFIC") and, in particular, our Taxation Steering Committee, regarding the Income Tax Act rules regarding superficial losses and stop losses and their applicability to mutual funds and mutual fund "fund-of-funds" portfolios which are subject to rebalancing. Fund-of-funds portfolios are mutual funds whose underlying holdings consist of other mutual funds.

Background

Under subparagraph 40(2)(g)(i) of the Income Tax Act, if a taxpayer's loss from the disposition of a property is considered a "superficial loss", it is deemed to be nil. "Superficial loss" is defined in section 54 to be a loss from the disposition of a property where the taxpayer or a person affiliated with the taxpayer acquires a property that is the same or identical property (called "substituted property") within 30 days before or after the disposition and still owns the property 30 days after the original disposition. Paragraph 53(1)(f) adds the amount of the superficial loss to the adjusted cost base of the substituted property, so that when there is a future disposition of this investment, the loss will either reduce the capital gain or increase the capital loss. The current definition of superficial loss in section 54 is effective for dispositions of property occurring after April 26, 1995.

The definition of a superficial loss in section 54 excludes a disposition to which subsection 40(3.4) applies. Subsection 40(3.4) contains stop loss rules which are very similar to the superficial loss rules except that they apply when the transferor is a corporation, trust or partnership, for dispositions occurring after April 26,1995. However, instead of the loss being added to the adjusted cost base of the substituted property, it is kept suspended and can only be claimed by the transferor when the property is no longer owned by the transferor or an affiliated person. Mutual fund trusts and corporations would be caught under subsection 40(3.4).

Mutual Fund and Portfolio Rebalancing

Within the mutual funds industry, one of the most common mechanisms that is used within investment portfolios to allow for proper diversification is daily or monthly rebalancing, which can occur with respect to a mutual fund's equity holdings, with fully indexed funds or with fund-of-funds portfolios. The purpose of rebalancing is to realign the underlying mutual funds or the underlying asset holdings of a portfolio back to the recommended asset allocation targets. Rebalancing is required as market activity may cause one or more underlying assets or funds to either exceed or fall below their original allocation. Rebalancing is accomplished by selling sufficient assets or fund units which have exceeded their original allocation and purchasing assets or fund units which are below their original allocation in order to return to the originally recommended asset mix. Given the level of market activity and the type of funds, rebalancing may occur monthly or as often as daily. If daily rebalancing occurs, the same underlying assets or funds may be sold and repurchased within a short period of time to ensure that the portfolio is kept in line.

In a simplified example, let's assume that a fund-of-funds portfolio holds two funds - Fund A and Fund B. Each underlying fund has an allocation of 50%. Fund A exceeds its allocation due to market activity and is now 52% of the portfolio, while Fund B is now 48%. In order to make sure that the portfolio stays in line with its recommended allocation, 2% of Fund A will be sold and 2% of Fund B will be purchased in order to return to the recommended asset mix. If rebalancing does not occur, the asset mix of the portfolio will drift away from its original recommendation.

The sale of mutual funds or assets within a rebalancing scenario could result in losses with a repurchase of the same mutual fund or asset within a 30-day period. Any losses recognized by the mutual fund trust or corporation upon rebalancing, according to subsection 40(3.4), would be frozen indefinitely. In contrast, any realized capital gains would be recognized immediately.

Request for Exemption from Subsection 40(3.4) and Subparagraph 40(2)(g)(i)

The purpose of the superficial and stop loss rules is to prevent a taxpayer or an affiliated person from artificially creating losses while the taxpayer continues to hold the investment. However, the purpose of rebalancing the assets of a mutual fund, a fully indexed fund or the funds within a fund-of-funds portfolio is not to realize losses, but rather to ensure that the investment is in line with its guidelines. Accordingly, we feel that neither subsection 40(3.4) nor subparagraph 40(2)(g)(i) should be applicable to either mutual fund trusts or corporations, and request that they be exempt from these rules.

We request that you review this letter and provide us with a response regarding your decision. If you require further information on this issue, members of our Taxation Steering Committee would be pleased to assist you.

Yours very truly,

"ORIGINAL SIGNED BY T. HOCKIN"

Honourable Thomas A. Hockin
President and Chief Executive Officer