IFIC
THE INVESTMENT FUNDS INSTITUTE OF CANADA
L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA
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April 6, 2000

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

Dear Simon:

Re: Superficial and Stop Loss Rules Relating to Mutual Funds

I am writing further to our letter of August 4, 1999 and your subsequent telephone discussions with Darlene French and Laura White, members of our Taxation Steering Committee, with respect to the superficial loss rules in subparagraph 40(2)(g)(i) of the *Income Tax Act* (the "Act") and the new stop loss rules in subsections 40(3.3) and (3.4) of the Act. We are requesting an amendment to the Act which would exclude mutual fund trusts and mutual fund corporations from the application of those rules. You have asked us to provide a more detailed explanation of how those rules operate unfairly to mutual funds and their investors.

As you know, a mutual fund is a pooled fund investment vehicle for multiple investors. An investment in a mutual fund provides a number of advantages over a direct investment by an individual in a portfolio of securities, including access to premier professional investment management, a diversified portfolio, economies of scale and relative peace of mind. Tax considerations should not be a relevant factor for an investor when choosing between an investment in a mutual fund and a direct investment in a portfolio of securities. For the most part, the rules in the Act are designed so that a mutual fund is a tax neutral investment. However, the inability of a mutual fund to allocate losses to investors compromises the neutrality of mutual funds. The superficial loss rules and the new stop loss rules exacerbate the problem.

As we understand it, the purpose of the superficial loss rules is to prevent the selective crystallisation of losses when an investor continues to hold a position in the loss security. It is not clear for what purpose the more restrictive stop loss rules were introduced. However, in many cases they will have the effect of permanently trapping denied capital losses within the mutual fund because mutual funds continue indefinitely and do not dramatically change their investment objectives over time.

Before describing the impact of the superficial loss rules on mutual funds, it is worth observing that even if the investment managers of a mutual fund were inclined to engage in loss crystallisation, they do not have wide-open discretion to do so. Each mutual fund has a specific investment mandate that is set out in its declaration of trust (or articles of incorporation). The investment managers must operate within that mandate. In some cases a mutual fund's investment mandate is very restrictive and provides virtually no discretion to the investment manager. For example, the top fund in a fund-on-fund arrangement and index funds have very restrictive investment mandates and the investment manager may have no choice but to buy and sell the same securities over and over again. Perhaps more importantly, it is worth noting that the investment managers of mutual funds are not inclined to engage in tax-motivated transactions, such as the crystallisation of loss. Investment managers are motivated by the desire to maximize investment returns. Investment returns are measured on a pre-tax basis. The crystallisation of losses has absolutely no impact on a mutual fund's pre-tax investment performance.

The following are some illustrations of how the superficial and stop loss rules impact negatively on mutual funds simply because of the way mutual funds operate.

Redemptions and Subscriptions

The role of a mutual fund is to remain fully invested according to its investment mandate. As subscription proceeds are received from new investors, the fund must buy additional securities and similarly, the fund must sell securities to pay redemption proceeds when an investor redeems his or her units.

Accordingly, gains and losses are realized on a regular, if not daily, basis simply to deal with the comings and goings of investors. A mutual fund will buy and sell securities of the issuers that comprise its investment portfolio in order to satisfy its investment mandate. In other words, a mutual fund does not (nor should it) deviate from its investment mandate to accommodate the superficial losses that arise from the purchase of assets with subscription proceeds and the sale of identical assets to pay redemption proceeds.

Those funds with a very restrictive investment mandate will have no flexibility in this regard. For example, in a fund on fund arrangement, the top fund will typically be required to keep the amount of its investment in the bottom fund within a 5% range measured as a percentage of the net asset value of the top fund. For example, a top fund that invests in three other funds in specified proportions may be restricted so that it can only invest between 17.5% to 22.5% in fund A, 50% to 55% in fund B and 27% to 32% in fund C. Similarly, so-called, index funds are designed to track a basket of securities in order to achieve the same investment return as a particular stock index, such as the TSE 300 or S&P500. Accordingly, an index fund must remain as fully

invested as possible (i.e., no cash) and must carefully maintain the proper proportion of securities as reflected in the index it is tracking. The same securities must be bought and sold over again as subscriptions and redemptions are processed.

The repetitive purchase and sale of identical investments to accommodate subscriptions and redemptions results in gains being realized and losses being permanently denied since the mutual fund cannot change its investment mandate and therefore, cannot fully divest itself of a particular security for any 60-day period to avoid the superficial loss rules.

Because of the denial of capital losses, net capital gains will be over-stated and can be expected to result in a greater distribution to non-redeeming investors. More specifically, the capital gains refund mechanism will not operate properly through the course of time where losses cannot be netted against gains. In the end, the denial of losses has the effect of accelerating the recognition of gains for those investors who are not redeeming (i.e., for those investors who are not realizing gains or losses from the redemption of units). The gains and losses resulting from the sale of securities by the mutual fund to pay redemption proceeds are beyond the control of the fund. They do not arise from a desire to crystallize gains or losses for any tax motivated reason. Rather, they arise because units of an open-end mutual fund trust must be fully redeemable upon demand, by virtue of the definition of "mutual fund trust" and "unit trust" in the Act.

Rebalancing a Mutual Fund's Investment Portfolio

In addition to the investment objectives set out in its declaration of trust (or articles of incorporation), a mutual fund is governed by National Instrument 81-102. Among other things, National Instrument 81-102 imposes extensive investment restrictions on mutual funds. We attach a copy of those investment restrictions as illustration.
General concentration restrictions preclude mutual funds from purchasing securities of an issuer if after the purchase the fund would have more than 10% of its net assets invested in the securities of that issuer. In the case of fund on funds, a fund can only have 10% of its net assets invested in units of other funds, in aggregate. The index funds and fund on funds described above under "Redemptions and Subscriptions" have obtained relief from the securities regulators to exceed this 10% limit.

Mutual funds are also subject to control restrictions under s. 2.2 of National Instrument 81-102 that prohibit a fund from purchasing securities of an issuer if after the purchase it would hold more than 10% of the outstanding voting or equity securities of that issuer. If the mutual fund exceeds this 10% threshold other than through a purchase, the fund has a maximum of 90 days to reduce its holdings to 10%.

This rebalancing activity may result in the realization of a gain or loss, which loss may be denied under the stop loss rules. The activity is not prompted by the desire to crystallize tax losses. Further, as noted above, a fund does not generally have the flexibility to fully divest itself of a particular security for 60 days to avoid the superficial/stop loss rules.

Year-End Distributions

There is a mechanical problem for mutual fund trusts that relates to the calculation of income at year-end. As you know, mutual fund trusts must calculate and distribute their income at the end of each year. The recent introduction of section 132.11 of the Act provided welcome relief from the impossibly short time-frame within which mutual funds were required to calculate and distribute their income.

The superficial loss rules create an additional uncertainty given that a mutual fund cannot know whether losses realized in December are superficial losses until the end of January. It is impossible to anticipate future investment activity that would retroactively cause a loss to the superficial loss. If a loss is subsequently established to be a superficial loss, capital gains will have been understated at year-end and will have been insufficiently distributed. The mutual fund cannot simply choose to pay tax on the underdistributed amount for a variety of legal, practical and business reasons, including the fact that it would compromise the tax neutrality of the investment vehicle and the fact that investors have acquired units of the fund on the understanding that the fund would not pay tax. The problems associated with the inaccurate calculation and distribution of income have been previously discussed with you and were outlined in detail in our submissions in late 1998 in context of the introduction of section 132.11 of the Act. We would be happy to provide you with a copy of our previous submissions on request.

Relief Sought

We submit that the superficial loss rules operate unfairly in the context of mutual funds because superficial losses are not incurred by mutual funds for tax-motivated reasons, but rather because of the natural operation of a mutual fund as a pooled investment vehicle. Yet the superficial loss rules have the effect of accelerating the recognition of capital gains for those unitholders who do not divest themselves of their units in the mutual fund. Because of inflexible investment mandates, the inability to allocate losses to investors and the new stop loss rules, superficial losses realized by mutual fund will be permanently trapped within mutual funds. We submit that while it may be appropriate for the superficial loss rules to apply at the investor level, it is not appropriate for them to apply at the mutual fund level for the reasons outlined above. Therefore, we respectfully request that mutual fund trusts and mutual fund corporations be exempt from the application of the superficial loss rules in subparagraph 40(2)(g)(i)

of the *Income Tax Act* (the "Act") and the new stop loss rules in subsections 40(3.3) and (3.4) of the Act.

If you require further information on this issue, please feel free to contact either Laura White at 416-947-8903 or Janice Russell at 416-365-8810 of IFIC's Taxation Steering Committee directly.

Yours very truly,

THE INVESTMENT FUNDS INSTITUTE OF CANADA

"ORIGINAL SIGNED BY T. HOCKIN"

Honourable Thomas A. Hockin
President and Chief Executive Officer