



THE INVESTMENT FUNDS INSTITUTE OF CANADA
L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA
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August 24, 2000

DELIVERED

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

Dear Mr. Martin:

RE: Subsection 107(1)(c)

I am writing you regarding an apparent technical anomaly in the operation of paragraph 107(1)(c) of the *Income Tax Act* (Canada) (the "Act"). Paragraph 107(1)(c) is a so-called stop-loss rule which, in very general terms, is intended to apply to the following situation:

- (1) A person purchases an interest in a trust which holds shares of Canadian corporations.
- (2) The shares held by the trust pay dividends (either taxable dividends or capital dividends) which are flowed through to the beneficiary as designated dividends pursuant to either subsection 104(19) or 104(20) of the Act. The effect of flowing through the dividends is to reduce the value of the beneficiary's interest in the trust.
- (3) The beneficiary sells its interest in the trust at a loss.

It is clearly reasonable as a policy matter for the loss of the beneficiary to be reduced by the amount of dividends flowed through to it to the extent that such dividends are tax-free to the beneficiary (e.g., taxable dividends received by a corporate beneficiary or capital dividends received by certain other beneficiaries).

However, the stop-loss system in paragraph 107(1)(c) appears to operate on an aggregate interest basis rather than on a unit by unit basis and thus can produce an unreasonable result.

For example, suppose that a corporation or a trust (including testamentary trusts) acquires 20 units of a unit trust at \$100 each. Suppose that the corporation or trust receives \$1 of taxable dividends in respect of each unit. Finally, suppose that the corporation or trust sells one of the units for \$70. In our view, the amount of the loss reduction in respect of the unit sold should be \$1. However, there would appear to be a significant concern that the amount of the loss reduction is \$20. The preamble to the stop-loss rule in paragraph 107(1)(c) reads as follows:

"Where a taxpayer has disposed of *all or, any part of the taxpayer's capital interest* in a trust" (*emphasis added*)

If the trust unit disposed of in the example constitutes a separate capital interest in the trust, the amount of the loss reduction under paragraph 107(1)(c) upon the disposition will be restricted to the dividends allocated to the beneficiary in respect of that unit. Alternatively, if the trust unit disposed of constitutes a part of a capital interest, the amount of the loss reduction under paragraph 107(1)(c) will be the total of all dividends allocated to the beneficiary in respect of such capital interest. As a result of the amendments currently proposed to the definition of capital interest in subsection 108(1) of the Act, it is difficult to argue that a single trust unit constitutes a separate capital interest. The proposed new wording reads, in part, as follows:

"capital interest' of a taxpayer in a trust means all rights of the taxpayer as a beneficiary under the trust . . ."

In contrast, the relevant parts of the old wording are as follows:

"capital interest' of a taxpayer in a trust means . . . a right of the taxpayer as a beneficiary under the trust . . ."

Under the old wording, each unit constituted a "right" and thus each unit arguably constituted a separate capital interest. However, under the new wording which refers to "all rights of the taxpayer", it is obviously difficult to argue that each unit constitutes a separate capital interest. Thus, the amount of the loss reduction in the example under discussion would likely be \$20.

The analysis above was in respect of taxable dividends. However, the analysis would be substantially the same if the unit trust received and designated capital dividends. The principal difference is that the stop-loss rule in paragraph 107(1)(c) would apply more broadly to include not only corporations and trusts but also individuals.

In considering the issue raised by this letter, there are two further points that we wish to draw to your attention. Firstly, all of the stop-loss rules in section 112 operate on a share by share basis. Secondly, consider the situation where a taxpayer owns a number of trust units, receives dividends in respect of all of them and then disposes of most of them for a gain. Suppose that at some subsequent time the taxpayer reacquires a number of trust units but does not receive any dividends in respect of such units. Finally, suppose the taxpayer ultimately disposes of all of its trust units at a loss. In our view, it does not make policy sense for the dividends received during the first holding period to reduce the losses realized during the second holding period simply because of a small number of units held continuously throughout both holding periods.

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We believe that a simple remedy to the technical anomaly that we have described would be to amend the definition of capital interest to define each unit of a unit trust as a separate capital interest for the purposes of paragraph 107(1)(c).

Obviously this letter is of a highly technical nature and thus Members of The Investment Funds Institute of Canada's Taxation Steering Committee would be pleased to discuss it directly with your officials at their convenience. Thank you for your attention to this matter.

Sincerely

THE INVESTMENT FUNDS INSTITUTE OF CANADA

“ORIGINAL SIGNED BY T. HOCKIN”

Honourable Thomas A. Hockin
President & Chief Executive Officer

cc: Mr. Lawrence Purdy