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TL-16

James Carman
Senior Policy Advisor, Taxation
The Investment Funds Institute of Canada
11 King Street West, 4th Floor
Toronto, ON MSH 4C7

Dear Mr. Carman:

SUBJECT: Application of the foreign affiliate "tracking arrangement" rules in subsections 95(8) to (12) of the *Income Tax Act*

I am writing in response to the various communications of The Investment Funds Institute of Canada ("IFIC") with the Tax Legislation Division concerning IFIC's request for an amendment to ensure that neither of subsections 95(11) and (12) of the *Income Tax Act* (the "Act") applies to cause certain investment funds that are structured as non-resident "umbrella corporations" to be treated as controlled foreign affiliates of Canadian investors. Those provisions are among the foreign affiliate "tracking arrangement" rules, in subsections 95(8) to (12) of the Act, that were contained in Bill C-86, which received Royal Assent on December 13, 2018. Those rules apply in respect of taxation years of foreign affiliates beginning after February 26, 2018.

IFIC observes that it is common in the asset management context for non-resident investment funds holding portfolio investments to be structured as umbrella corporations. An umbrella corporation is a single corporation comprising several sub-funds that are traded as individual investment funds, with the assets and liabilities of each sub-fund being separate from those of each other sub-fund. Umbrella corporations typically issue multiple classes of participating shares, each of which provides shareholders with exposure to the returns on assets of a particular sub-fund and not assets of other sub-funds of the umbrella corporation.

Shares of an umbrella corporation generally constitute a tracking interest in respect of the umbrella corporation, within the meaning of subsection 95(8), since the fair market value of those shares is determined by reference to the assets

of the corresponding sub-fund and not the assets of other sub-funds of the umbrella corporation. If a taxpayer owns 10 per cent or more of a class (or series) of shares of a non-resident umbrella corporation, the umbrella corporation is a foreign affiliate of the taxpayer. Accordingly, the conditions set out in subsection 95(10) are met, with the result that subsection 95(11) will apply in respect of the umbrella corporation. In some cases, the application of subsection 95(11) could, in effect, cause the sub-fund in which the taxpayer is invested to be deemed to be a separate non-resident corporation that is a controlled foreign affiliate of the taxpayer for the purposes set out in subsection 95(11). Notably, these purposes include the purpose of determining the amounts, if any, to be included under subsection 91(1) in computing the taxpayer's income.

IFIC asserts that foreign asset managers, dealing at arm's length with investors, often structure investment funds as non-resident umbrella corporations – rather than housing each investment fund within a separate non-resident corporation – for reasons such as to allow greater flexibility and reduce non-tax costs, and not to assist any Canadian taxpayer in avoiding the foreign accrual property income ("FAPI") rules in the Act. Similarly, for reasons that do not include avoidance of the FAPI rules, Canadian-resident investors, including Canadian-resident investment funds, commonly seek to gain exposure in their investment portfolios to the returns on the foreign assets within a sub-fund of a non-resident umbrella corporation that is managed by an arm's length foreign asset manager by acquiring shares of the corresponding class. Another example is that Canadian asset management companies with a global focus and global customer base sometimes launch or manage sub-funds within non-resident umbrella corporations, and often make "seed capital" investments in a sub-fund (either directly or through a foreign subsidiary) to cover start-up costs and allow the fund to establish a track record during the initial, seeding stage. IFIC is of the view that, in all of these cases, it is not appropriate in policy terms to apply the tracking arrangement rules, and by extension the FAPI rules.

IFIC also notes that non-resident investment funds often issue separate classes (or series) of shares to investors resident in different countries and enter into currency hedging contracts to hedge investors' foreign currency exposure back to the currency of their country of residence. Under the tracking arrangement rules, these currency hedging contracts may in certain cases cause

(i) Canadian investors to be considered to have a tracking interest in respect of a fund, or

(ii) a sub-fund of a foreign umbrella corporation to be a controlled foreign affiliate of Canadian investors under subsection 95(11), by differentiating the tracked property and activities in respect of the

class (or series) of shares held by Canadians from those in respect of classes (or series) held by investors resident in other countries.

IFIC is of the view that these results are also inappropriate in policy terms.

Our Comments:

The rules in subsections 95(10) to (12) of the Act are intended to prevent taxpayers from avoiding accrual-based taxation of FAPI by using a tracking arrangement in respect of a foreign affiliate to avoid controlled foreign affiliate status. In a recent submission to the Department, one of IFIC's members recommended an amendment to the Act that would, in effect, provide an exception from subsections 95(11) and (12) where it cannot reasonably be considered that one of the purposes for the creation or issuance of a tracking interest in respect of an umbrella corporation, or the acquisition of the interest by a taxpayer, is to avoid the corporation being a controlled foreign affiliate of the taxpayer.

We agree that an acquisition, or holding, by a taxpayer (or a foreign affiliate of the taxpayer) of shares of a non-resident umbrella corporation that constitute a tracking interest in respect of portfolio investments in a sub-fund of the umbrella corporation is beyond the intended scope of this 2018 budget measure if it cannot reasonably be considered that one of the purposes for the acquisition or holding, or for the taxpayer's investment being made through an umbrella corporation rather than a non-resident corporation housing only the sub-fund, is to permit a taxpayer to avoid an income inclusion under subsection 91(1). We are therefore prepared to recommend to the Minister of Finance that the Act be amended in a manner that ensures that neither subsection 95(11) nor (12) applies to cause an umbrella corporation to be a controlled foreign affiliate of a taxpayer in those circumstances.

We are also prepared to recommend amendments to ensure that where a non-resident investment fund enters into currency hedging contracts in the circumstances described above, this fact will not cause

(i) a taxpayer to be considered to have a tracking interest in respect of the fund, or

(ii) if a taxpayer otherwise has a tracking interest in respect of the fund (*e.g.*, an umbrella corporation), the tracked property and activities in respect of that tracking interest to be considered distinct from the tracked property and activities in respect of tracking interests of other investors in the corporation for the purposes of subsection 95(11).

We will recommend that the above-noted amendments be effective for taxation years of foreign affiliates beginning after February 26, 2018.

While we cannot offer any assurance that either the Minister of Finance or Parliament will agree with our recommendations in respect of this matter, we hope that this statement of our intentions is helpful.

Yours sincerely,

Brian Ernewein
Assistant Deputy Minister – Tax Legislation
Tax Policy Branch