THE INVESTMENT FUNDS INSTITUTE OF CANADA
L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA

Joanne De Laurentiis
PRESIDENT AND CEO
Tel: (416) 309-2300
E-mail: jdlaurentiis@ific.ca

By e-mail to gerard.lalonde@fin.gc.ca

May 29, 2009

Mr. Gérard Lalonde
Director, Finance Canada
Tax Legislation, Director's Office
140 O'Connor Street
Ottawa, Ontario Canada K1A 0G5
Tel: (613) 995-0405/Fax: (613) 992-4450
E-mail: gerard.lalonde@fin.gc.ca

Dear Mr. Lalonde:

Re: International Taxation Matters

The Investment Funds Institute of Canada (IFIC) would like to discuss two international tax matters with you and your colleagues. IFIC is the voice of Canada's investment funds industry, representing fund managers, distributors and industry service organizations that work together to enhance the integrity and growth of the industry and strengthen investor confidence. Financial services make up a growing percentage of Canada's economy and are a recognized competitive advantage for our country. We think that ensuring the Canadian investment fund industry is on a level playing field with competitors around the globe is important to our economy and Canadian investors and taxpayers.

Advisory Panel Recommendations

On July 15, 2008, IFIC made a submission to the Advisory Panel on Canada's System of International Taxation. A copy of that submission is attached to this letter. IFIC and its members were very pleased that the Panel's Final Report, "Enhancing Canada's International Tax Advantage" (December 2008), indicated that the two problems raised in our submission merited further analysis (see sections 4.159, B.32 and B.33 of the Final Report). IFIC would appreciate the opportunity to work with you in the preparation of such further analysis.

Foreign Investment Entity (FIE)/Non-Resident Trust (NRT) Measures

IFIC reviewed with interest the statement in the last budget that Finance supports the objective of the FIE/NRT measures, but that it will review the various submissions on the measures before proceeding further with them. IFIC has made a number of submissions

to the Department of Finance on the matters (February 26, 2007; January 28, 2008). There are two particular concerns that we wish to emphasize:

(a) IFIC has always been, and continues to be, concerned about the complexity of the measures. We believe the complexity, and the resulting compliance costs, are disproportionate to the intended benefits of the measures.

(b) IFIC is concerned about the effects of the measures on the ability of Canadian mutual funds to make legitimate investments in foreign securities. The measures as currently drafted effectively prohibit certain investments, notwithstanding that such investments do not result in tax avoidance. We are aware that discussions are currently underway to exempt pension funds from the application of the measures in certain circumstances. In order to put the retirement savings of all Canadians on a level playing field, we believe that Canadian mutual funds should be treated similarly to Canadian pension funds.

IFIC would very much like to have the opportunity to meet with officials of the Tax Policy Branch to further discuss the above matters. We will call your office shortly to discuss alternatives for a meeting at your convenience.

Thank you very much for your continued consideration of IFIC's concerns on tax issues.

Yours truly,

THE INVESTMENT FUNDS INSTITUTE OF CANADA
L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA
IFIC
11 KING ST. WEST, 4TH FLOOR, TORONTO, ONTARIO, M5H 4C7 TEL 416 363-2158 FAX 416 861-9937 WEBSITE www.ific.ca

BY E-MAIL AND FAX

July 15, 2008

Advisory Panel on Canada's System of International Taxation
333 Laurier Ave W., 15th Floor
Ottawa ON K1A 0G5
Attention: Mr. David Messier
E-mail: advisorypanel@apcsit-gcrcfi.ca
Fax: (613) 947-2289

Dear Panel Members:

Re: Treatment of Imported and Exported Financial Advisory Services

The Investment Funds Institute of Canada (IFIC) is pleased to respond to the Advisory Panel's request for comments on Canada's system of international taxation. IFIC is the voice of Canada's investment funds industry and includes fund managers, distributors and industry service organizations that work together in a cooperative forum to enhance the integrity and growth of the industry and strengthen investor confidence.

Canada is a trading nation, whose combined value of exported and imported goods and services equals an estimated two-thirds of the country's GDP. Financial services make up a growing percentage of Canada's economy and are a recognized competitive advantage for our country. Through mutual funds, one in two Canadians invest in capital markets, helping to create a stronger, more prosperous Canada. About 90,000 Canadians are employed in the mutual fund industry, assisting in channeling resources to Canadian companies for growth and expansion. Currently, Canadians have shown their confidence in the industry by investing about $700 billion in mutual funds.

Ensuring that the Canadian investment fund industry is on a level playing field with competitors around the globe is critical to both our industry and Canadian investors. We believe that steps must be taken to remove measures that make Canadian investment fund managers less competitive than others in the world. We therefore request the Advisory Panel to address in its final report the following two issues that place the Canadian investment industry at a disadvantage in the international capital marketplace:

1. **Imported Financial Services:** A Canadian investment fund manager acquires or establishes operations outside of Canada. The Canadian investment fund manager engages its newly acquired or established offshore affiliates to provide investment advisory services to its Canadian mutual funds. The service fees paid to the offshore affiliates will be foreign accrual property income (FAPI), with potentially adverse results. In contrast, this result will not prevail if the Canadian

investment fund manager engages an unrelated foreign person to provide the investment advisory services. In addition, a foreign investment fund manager with a Canadian mutual fund business is able to provide investment advisory services to its Canadian mutual funds without such potentially adverse results. The result is that Canadian investment fund managers are at a competitive disadvantage and are discouraged from expanding offshore.

2. **Exported Financial Services:** A Canadian investment fund manager provides investment advisory services to foreign investment funds. The volume of trading and other facts are sufficient to cause the foreign investment funds to be viewed as carrying on a business in Canada. Section 115.2 of the *Income Tax Act* exempts the foreign investment funds from Canadian income tax, provided that certain conditions are satisfied. One of the conditions is that the advice is in respect of a "qualified investment". Shares of private companies that derive their value primarily from real properties or resource properties in Canada are excluded from the definition of "qualified investment". In contrast, where a foreign investment fund resident receives similar advice from a foreign investment fund manager, the foreign investment fund is not viewed as carrying on business in Canada and thus does not become subject to Canadian income tax. This result places Canadian investment fund managers at a competitive disadvantage in advising on Canadian investments relative to foreign investment fund managers.

The two issues identified above are described in more detail in the two appendices attached to this submission. IFIC and its professional advisors would be pleased to provide further information at any time on either of the two issues, including in a meeting with members of the Advisory Panel. Thank you very much for your consideration of this submission.

Sincerely,

THE INVESTMENT FUNDS INSTITUTE OF CANADA

Joanne De Laurentiis
President & CEO

APPENDIX A

IMPORTED FINANCIAL SERVICES

IFIC believes that a technical amendment to the *Income Tax Act* (the "Act") should be enacted to expand the scope of the safe harbour from foreign accrual property income ("FAPI") in subsection 95(3)[1] so that it is available where certain services are performed by a controlled foreign affiliate for its Canadian parent company or an affiliate. The effect of the amendment will be to permit Canadian investment fund managers to compete on a level playing field with foreign investment fund managers. This in turn will permit international expansion by Canadian investment fund managers.

Background

The typical mutual fund product line of a Canadian investment fund manager (a "Manager") includes, among others, a Canadian exposure equity fund, a U.S. exposure equity fund, a European exposure equity fund and an Asian exposure equity fund.[2] The investment advisory function for the Canadian exposure equity fund is almost always carried out in Canada by the Manager. However, the investment advisory function for the foreign exposure equity funds is typically performed in the respective geographic regions by foreign sub-advisors with superior knowledge of the investment opportunities in those regions (i.e., the U.S. exposure equity fund is advised by a U.S.-based sub-advisor, the European exposure equity fund is advised by a European-based sub-advisor and the Asian exposure equity fund is advised by an Asian-based sub-advisor).

There are various possible legal relationships between the foreign sub-advisor and the Manager. For example, the sub-advisor may be unrelated to the Manager. Alternatively, the sub-advisor may be a non-resident parent (or affiliate of the parent) of the Manager. Finally, the sub-advisor may be a wholly owned foreign subsidiary ("Forco") of the Manager. In the latter situation, Forco will have its own employees and the necessary systems, expertise and licences to carry out the investment advisory function in the foreign jurisdiction.

Paragraph 95(2)(b)

Paragraph 95(2)(b) applies where a controlled foreign affiliate provides services and the amount paid or payable in consideration for those services is deducted in computing the income from a business carried on in Canada by any person in relation to whom the affiliate is a controlled foreign affiliate or other non-arm's-length person. Where applicable, paragraph 95(2)(b) deems the provision of services to be a separate business other than an active business carried on by the affiliate. Thus, in the situation of the Manager and Forco described above, the income of Forco is potentially FAPI. This will result in adverse consequences to the Manager in two circumstances: firstly, where an incremental amount of Canadian income tax is payable relative to the income

---

1 Unless otherwise noted, all statutory references in this letter are to provisions of the *Income Tax Act* (Canada).

2 The various mutual funds will all be resident in Canada, but will hold securities issued by companies resident in the specified jurisdiction.

tax payable in the jurisdiction of the controlled foreign affiliate and, secondly, where the controlled foreign affiliate has losses from other business activities that it is not able to offset against its FAPI for Canadian income tax purposes.

Tax Policy

The application of paragraph 95(2)(b) as described above negatively affects the ability of Canadian investment fund managers to compete with foreign investment fund managers in foreign markets and thereby expand their businesses outside of Canada. For example, consider the situation where a Manager establishes or acquires an Asian subsidiary which has an investment funds business of its own. The Asian subsidiary will likely be providing investment advisory services to some of the foreign mutual funds offered by it to Asian investors. Suppose that, in addition, it decides to use its resources and expertise to provide investment advisory services to the Manager for the benefit of the Asian exposure equity fund offered by the Manager to Canadian investors, thereby taking advantage of potential economies of scale. Unfortunately, the fees paid by the Manager to the Asian subsidiary for such services will potentially be FAPI. Clearly this result has the potential to discourage the Manager from expanding its operations into foreign markets.

In comparison, consider the situation of a Manager which is a wholly-owned subsidiary of an Asian parent. If the Manager in this circumstance engages the parent to provide investment advisory services for the benefit of the Asian exposure equity fund of the Manager, the Canadian foreign affiliate and FAPI rules obviously will be of no relevance. In addition, the Asian equivalent of the Canadian FAPI rules will typically not apply.[3] Thus, foreign tax rules typically facilitate the offshore expansion of foreign mutual fund managers. In the long term, this asymmetry between foreign tax rules and the Canadian rules will result in pressure for "hollowing out" another Canadian industry in favour of foreign mutual fund managers.

IFIC clearly recognizes that the policy underlying paragraph 95(2)(b) (and the FAPI rules generally) is to prevent the movement of business activities away from Canada in circumstances where such activities could otherwise be performed in Canada. However, this is not the case with the investment advisory services discussed in this submission. It is clear that such services are best provided in the jurisdictions to which they relate. In this regard, we note the comments of the Department of Finance in a September 14, 2001 comfort letter that discussed the tax policy underlying paragraph 95(2)(b) and subsection 95(3). The comfort letter stated as follows:

> "Paragraph 95(3)(a) ensures that the transportation of persons or goods 'is excluded from constituting' services for the purposes of paragraph 95(2)(b). The provisions of paragraph 95(3)(a) do not offend paragraph 95(2)(b), as there is no erosion of the tax base or diversion of income from Canada if the services are required by the very nature to be performed outside Canada. Specifically, the transportation of persons or goods outside Canada is, by its very nature, a service

[3] Or the U.S. Subpart F rules in the context of a U.S. parent.

> that must be performed outside Canada and is therefore markedly different from services that otherwise could have been performed in Canada."

As previously noted, it is clear that the investment advisory services discussed in this submission are not services that it is reasonable to expect could otherwise be performed in Canada.

Recommended Amendment to Subsection 95(3)

To address the problem described in this submission, we submit that the definition of "services" in subsection 95(3) should be amended by adding paragraph (e) as follows:

> "(e) services performed by a person who is not resident in Canada, all or substantially all of which relate to the acquisition, holding or disposition of foreign securities by a person who is resident in Canada"

APPENDIX B

EXPORTED FINANCIAL SERVICES

Section 115.2 was added to the Act in the early 1990s to deal with the situation where a Canadian investment fund manager was providing investment advisory services to a foreign investment fund. The activity of providing such services arguably caused the foreign investment fund to be viewed as carrying on business in Canada and therefore taxable in Canada. In contrast, where the foreign investment fund acquired an identical investment portfolio based on advice from a foreign investment fund manager, the foreign investment fund was not considered to be carrying on business in Canada and thus did not become taxable in Canada. This result obviously placed Canadian investment fund managers at a significant competitive disadvantage relative to foreign investment fund managers. The enactment of section 115.2 went a significant distance towards addressing this anomalous result. The section was refined in some material ways by the enactment of certain amendments announced in the 2001 federal budget.

Unfortunately, the section does not go far enough in one material respect. The advice received by the foreign investment fund must be in respect of a "qualified investment". The definition of "qualified investment" excludes a share (referred to hereinafter as an "Excluded Share"):

> "(i) that is either
> (A) not listed on a designated stock exchange, or
> (B) … , and
> (ii) of which more than 50% of the fair market value is derived from one or more of
> (A) real property situated in Canada,
> (B) Canadian resource property, and timber resource property;"

Thus, if the advice provided by the Canadian investment fund manager is in respect of an Excluded Share, the profit realized by the foreign investment fund upon the disposition of the Excluded Shares will be generally subject to Canadian income tax.

However, suppose the foreign investment fund engages the services of an investment fund manager resident in the U.S. or other foreign jurisdiction. Suppose that the foreign investment fund purchases Excluded Shares based on investment advice from the investment fund manager resident in the U.S. or other foreign jurisdiction. The foreign investment fund will not be viewed as carrying on business in Canada. Thus, any profit realized by the foreign investment fund upon the disposition of the Excluded Shares will generally be exempt from Canadian income tax.

The foregoing is obviously an anomalous result. It prevents Canadian investment fund managers from competing on a level playing field with foreign investment fund managers. It is particularly anomalous that the disadvantage occurs where Canadian investment fund managers are advising on investments in their home jurisdiction.

Recommendation

IFIC submits that the definition of "qualified investment" should be amended to eliminate the Excluded Share concept.