October 31, 2014

**By Electronic Mail: Alexandra.Maclean@fin.gc.ca**

Ms. Alexandra MacLean
Director, Tax Legislation
Department of Finance
90 Elgin Street
Ottawa, ON KIA 0G5

Dear Ms. MacLean

**Re: Amendments to the Loss Restriction Event Rules in Bill C-43**

IFIC would like to thank the Minister and the Department for the proposed amendments to the loss restriction event rules in the *Income Tax Act* (Canada) (the "ITA") contained in Bill C-43. We believe that the proposed amendments will address many of the concerns faced by our members. However, we continue to have a number of concerns which we would like to see addressed, ideally through second reading amendments (although we understand that procedure is not widely used today), through a comfort letter or possibly through clarifying comments in the explanatory notes to Bill C-43. Unless otherwise noted, references herein to sections and components thereof are to the ITA as it is to be amended by Bill C-43.

**Definitions of "Investment Fund" and "Portfolio Investment Fund"**

(a) Reliance on 10% and 50% Tests from SIFT Rules

We observe that the permitted investment concentration rules in the definition of portfolio investment fund are drawn from the concept of "SIFT trust" in subsection 122.1(1).

As a general policy matter, we note that such permitted investment concentration rules do not align in a number of respects with those applicable to a prospectus-qualified mutual fund under National Instrument 81-102 ("NI 81-102") of the Canadian securities regulators. For example, under NI 81-102, a mutual fund may generally not purchase a security of an issuer, enter into a specified derivatives transaction or purchase index participation units if, immediately after the transaction, more than 10 per cent of the net assets of the mutual fund, taken at market value at the time of the transaction, would be invested in the securities of any issuer. In addition, a mutual fund may not purchase a security if, immediately after the purchase, the mutual fund would hold securities representing more than 10 per cent of the votes attaching to the outstanding voting securities of that issuer or the outstanding equity securities of that issuer.

Under the definition of "portfolio investment entity", a trust must ensure that it does not hold securities of a subject entity that have a total fair market value that is greater than 10 per cent of the equity value of the subject entity and that securities of the subject entity and affiliated entities do not have a fair market value that is greater than 50 per cent of the equity value of the trust. "Equity value" is defined in subsection 122.1(1). In the case of a corporation, it is the total fair market value of all of the issued and outstanding shares of the capital stock of the corporation and, in the case of a trust, it is the total fair market value of all of the income or capital interests in the trust.

We understand that a decision was made to define portfolio investment fund in terms of concepts drawn from the definition of SIFT trust in order to avoid introducing new concepts to the ITA. However, we observe that this will require most mutual funds to establish new investment restrictions and a process for monitoring compliance with them.

With respect to the former, as the time at which what would otherwise be a loss restriction event may occur may not be known in advance, a trust may be required to decide to comply with the new restrictions at all times. This is almost certainly the case in fund-on-fund situations. However, it does not seem appropriate that an investment manager of a *bona fide* investment fund may have to "sell down" a position in order for the trust to comply with the definition of portfolio investment entity. In addition, with respect to debt securities, the requirement that the trust not hold securities of an issuer that have a fair market value greater than 10 per cent of the equity value of the issuer may preclude investment in debt obligations of distressed issuers and other issuers that have nominal equity (such as notes issued by securitization vehicles that issue debt in order to purchase assets such as credit card receivables or other special-purpose vehicles). It does not seem that precluding investments in such securities is sound from a policy perspective.

The development of new systems to ensure compliance with additional restrictions on a continuous basis will involve significant cost. It may also require information that is not available on a continuous basis. Moreover, in order to determine that a trust was a portfolio investment fund at the time of what would otherwise be a loss restriction event in 2013 or in most of 2014, it is likely that this will require a manual determination. As a practical matter, at a minimum we submit that there should be additional transitional relief provided for 2013 and 2014 applicable to prospectus-qualified mutual funds that comply with the investment restrictions in NI 81-102 so that they would be treated as portfolio investment funds throughout 2013 and 2014.

(b) Funds Investing in Issuers That Own Real Property and Resource Property

We are concerned that the “reading rules” for the definition of “Canadian real, immoveable or resource property” (“CRIRP”), as it is to apply for the definition of “portfolio investment fund”, lead to anomalous results. Paragraph (a) of the definition is to be read without reference to “situated in Canada”, paragraph (b) is to be read as “a Canadian resource property or a foreign resource property” and the reference in paragraph (c) to timber resource property is to extend to rights outside Canada. As a result, pursuant to paragraph (d) of the definition, a share of a corporation or interest in a trust or partnership will be CRIRP if, for example, it derives more than 50 per cent of its value from real property or resource property, wherever located, unless the issuer is a taxable Canadian corporation, a SIFT trust, a SIFT partnership or a real estate investment trust as defined in subsection 122.1(1) (“REIT”).

It is not clear what policy concern requires that the loss restriction event rules apply to a trust that makes portfolio investments in foreign issuers that own foreign real estate or operate mines in foreign countries (such as foreign issuers like Exxon Mobil Corp. or BHP Billiton Limited). Presumably, the reason for including paragraph (d) in the definition of CRIRP as it applies for the purpose of defining a SIFT trust is to prevent a trust from investing indirectly in Canadian real property or resource property through a corporation or trust and the reason for carving out a taxable Canadian corporation, a SIFT Trust or a REIT in paragraph (d) is to allow an investment trust which would otherwise be a SIFT trust to invest indirectly in real property or resource property through an “acceptable” vehicle while investments in these “acceptable” vehicles would still be subject to the limits in paragraph (a) in the definition of “non-portfolio property”. The same policy concerns do not apply in the context of the definition of portfolio investment entity. Singling out funds that invest in these sectors appears to be arbitrary. Also, it would be difficult in practice for trusts that make portfolio investments in foreign issuers to determine whether more than 50 per cent of the fair market value of the securities of such issuers is derived from real or resource property or interests in such properties. Publicly available information such as consolidated financial statements of public issuers do not contain all of the information that is required.

We submit that, in applying the definition of CRIRP as it is to apply for the definition of "portfolio investment fund", it should be read without reference to paragraph (d).

(c) Cash on Deposit

We are also concerned that, as a bank deposit is a debt obligation of the bank, it is a "security" for the purposes of applying the definition of portfolio investment fund. While funds that are listed on an exchange generally do not maintain significant cash positions, in part because their units are not redeemable on a daily basis, funds that do redeem units on a daily basis do maintain some liquidity. In addition, some funds maintain cash balances due to market conditions or in the start-up phase and such balances may represent more than 50 per cent of the funds' assets. We recognize that, in some cases, an alternative to a bank deposit may be an investment in a money market fund (which should be a portfolio investment entity, subject to our comments on the 10 per cent test above). However, it is submitted that an amendment should be made that a bank deposit is not non-portfolio property if the amount payable by the bank under the deposit is equal to the amount deposited plus a fixed rate of interest. This would facilitate the day to day administration of investment trusts.

**Paragraph 251.2(3)(f)**

A loss restriction event may occur because an investor acquires units of the trust or because another investor redeems units of the trust, causing another investor or group of investors to be a majority interest beneficiary or majority interest group of beneficiaries. The "saving rule" in paragraph 251.2(3)(f) is drafted to refer only to the "acquisition" of equity of the particular trust and may be interpreted to refer only to the former.

We understand that this is not the result intended by the Department of Finance and that the Department believes that the reference to the "acquisition of equity of the particular trust by <u>a</u> person or group of persons" could be taken to include an acquisition of equity by the trust. We understand the argument but nonetheless have some reservations with it. We submit that paragraph 251.2(3)(f) should be amended to make it clear that it apples to "a transaction or event" that meets the conditions in subparagraphs (i) and (ii).

Given the broad meaning ascribed to the term “series of transactions or events” by the courts, there is some concern that subparagraph (ii) could be read such that becoming a portfolio investment fund in the course of launching a new fund or ceasing to be a portfolio investment fund as part of the normal termination of a fund could result in the test in subparagraph (ii) not being satisfied. We understand that this is not the result intended by the Department of Finance and request that the Explanatory Notes make this clear.

**Subsection 251.2(7)**

Subsection 251.2(7) provides that if a trust is subject to a loss restriction event in a taxation year, subsection 249(4) does not apply to end the year for certain purposes including paragraph 150(1)(c).

Subsection 150(1) requires that a return shall be “filed with the Minister… for each taxation year of a taxpayer, …(c) in the case of an estate or trust, within 90 days from the end of the year”. Presumably it is intended that if, for example, a trust is subject to a loss restriction event on May 1, the trust tax return for the taxation year ending on April 30 is to be filed within 90 days of the end of the taxation year that would otherwise have ended on December 15 or December 31. However, it is not clear that a separate return for the taxation year ending on April 30 is to be filed if paragraph 150(1)(c) does not apply to the April 30 taxation year.

Subsection 251.2(7) should also be amended to refer to the returns required under Part X.2 (subsection 204.7(1)) and under subsection 202(8) of the *Income Tax Regulations* (i.e., form NR4).

**Coming into Force Rules**

Clause 75(4) of Bill C-43 contains a coming into force rule. Trusts may elect to have the relevant relieving provisions apply from January 1, 2014 rather than March 21, 2013. A trust would presumably make such election if it had determined that it had a loss restriction event in 2013 and had made distributions and filed a tax return on that basis. We have been advised that a number of trusts that were subject to loss restriction events in 2014 prior to the release of proposed amendments applied the provisions of the ITA as they then read and have filed tax returns. We expect that there are others. The transitional rules should be amended to allow a trust to elect to have the relieving provisions apply from the date the proposed amendments were released.

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We would be pleased to provide any further information or answer any questions you may have. Please feel free to contact me by email at jcarman@ific.ca or by phone at (416) 309-2323.

Yours sincerely,

THE INVESTMENT FUNDS INSTITUTE OF CANADA

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