JOSÉE BAILLARGEON
Director, Taxation Policy | Directrice, Politique fiscale
jbaillargeon@sima-amvi.ca 416 309 2323

December 10, 2025

Delivered By Email: Trevor McGowan Trevor.McGowan@fin.gc.ca

Mr. Trevor McGowan
Associate Assistant Deputy Minister (Legislation)
Tax Policy Branch
Department of Finance

Dear Mr. McGowan:

RE: Definition of "Investment Fund" in Subsection 251.2(1) of the *Income Tax Act* (Canada) and its use Elsewhere in the Act

The Securities and Investment Management Association (**SIMA**) appreciates the opportunity to provide comments to the Department of Finance regarding the definition of "investment fund" in subsection 251.2(1) of the *Income Tax Act* (Canada) (the **Act**) and certain exemptions from alternative minimum tax (**AMT**) in section 127.55 of the Act.

Regarding some of the above topics, we have engaged separately in productive discussions with a number of officials of the Tax Policy Branch including Andrew Donelle, Zachary Fentiman, and Patrick Egit, and we acknowledge their assistance. Our concerns regarding the "investment fund" definition intersect with those officials' particular subject-matter expertise – including AMT, the loss restriction event (**LRE**) rules, and, since Budget 2025, the qualified investment (**QI**) rules. We concluded, however, that consolidating our views into one submission would be most useful. A separate submission will follow for QI-related issues that do not turn on the "investment fund" definition.

SIMA empowers Canada's investment industry and is the leading voice for the securities and investment management industry. The industry oversees approximately $4 trillion in assets for over 20 million investors and participates in the Canadian capital markets. Our members – including investment fund managers, investment and mutual fund dealers, capital markets participants, and professional service providers – are committed to creating a resilient, innovative investment sector that fuels long-term economic growth and creates opportunities for all Canadians.

We operate within a governance framework in which we gather input from our member working groups. The analyses and recommendations of these working groups are submitted to the SIMA board or board-level committees for direction and approval. This process ensures submissions that reflect the input and direction of a broad range of SIMA members.

I. Use of Investment Fund Definition in the Act

Background and General Recommendation

The term "investment fund", originally developed for the LRE rules, is now used elsewhere in the Act:

- **AMT**: Paragraph 127.55(f), which was amended in 2024 and is applicable to taxation years that begin after December 31, 2023, now provides an exemption from AMT for a trust
  - (a) that is an investment fund (as defined in subsection 251.2(1)), and
  - (b) that does not qualify as such in connection with transactions or events one of the main purposes of which is to avoid AMT.
- **Qualified Investments**: Budget 2025 has proposed that, effective November 4, 2025, the Act be amended to create two new categories of trusts whose units are a QI for registered plans, namely,
  - (a) a trust that is subject to, and substantially complies with, the requirements of National Instrument 81–102 Investment Funds, as amended from time to time, of the Canadian Securities Administrators (an **81-102 Trust**), and
  - (b) a trust that is an investment fund (as defined in subsection 251.2(1)) provided that the investments of the trust are managed by a person that is registered as an investment fund manager as described in *National Instrument 31–103 Registration Requirements, Exemptions and Ongoing Registrant Obligations*, as amended from time to time, of the Canadian Securities Administrators (an **IFM-Managed Trust**).

(These and any future uses of the "investment fund" definition outside of the LRE rules are referred to in this letter as "**Non-LRE Uses**".) Each of the two Non-LRE Uses listed above adopts the "investment fund" definition in subsection 251.2(1) without modification. That definition has flaws that in our view ought to be remedied for LRE purposes. Moreover, parts of the definition are not appropriate for Non-LRE Uses.

The investment fund definition was added to the Act as an exception to paragraph 251.2(2)(b), which provides that a trust is subject to a LRE if a person becomes a majority-interest beneficiary in the trust (or group becomes a majority-interest group of beneficiaries). The Act had, for many years, contained rules to constrain the trading of corporations' tax attributes, and the 2013 budget extended these rules to trusts.

The current investment fund definition is the product of extensive consultation between the Department of Finance and industry, resulting from multiple rounds of proposals, comments and discussion from 2013 to 2016 (see attached submission dated February 12, 2016). The definition is complex and, as discussed below, is challenging to monitor. We surmise that, from the Department of Finance's perspective, the definition's multiple, detailed requirements were necessary to address the loss trading concerns that drove the introduction of section 251.2. However, some of those requirements serve little purpose outside of the LRE rules.

While we go into specific shortcomings in the "investment fund" definition below, there is one overarching issue with the definition, and that is its requirement for its requirements to have been met "at all times" since certain dates.

- *Paragraph (a) of the definition*: this requires the trust to have a class of units outstanding that complies with the mutual fund trust conditions in paragraph 4801(a) of the Income Tax Regulations (Canada) (the Regulations) "at all times" since the later of March 21, 2013, and the end of the calendar year in which it is created.
- *Paragraph (b) of the definition*: this requires the trust to satisfy a host of requirements – including following a reasonable policy of investment diversification and not exceeding certain quantitative limits with regard to its ownership of certain issuers – "at all times" since the later of March 21, 2013, and the time of its creation.

Given these temporal requirements, if a trust fails to meet any one of the "investment fund" conditions at some point, it can never again requalify as an investment fund.

The "at all times" requirements have a clear rationale in the context of the mischief the LRE rules sought to address. Consider, for example, a unit trust with large losses that at some point ceases to be a reporting issuer, redeems all but one of its units and holds only nominal cash and say that a promoter wished to re-launch the trust and utilize the losses. In our view, it makes sense that the investment fund concept be designed in such a way that this trust's past history is relevant in the determination of eligibility to use the trust's losses in the present.

However, the "at all times" requirements are not suitable for Non-LRE Uses of "investment fund". In the context of AMT, other exemptions for trusts only require that the trust have the particular privileged status – such as being a mutual fund trust, a trust whose units are listed on a designated stock exchange, a prescribed master trust, etc. – throughout the year in which the trust is being tested for AMT liability. We see no reason why a trust's diversification or unit issuance history, for example, in a previous year should be relevant to whether it qualifies as an investment fund for purposes of determining its liability for AMT. Consider, similarly, what would happen if an IFM-Managed Trust QI category for investment funds were enacted as proposed, and a fund that intends to be an "investment fund" has a foot-fault – for instance, if an underlying investment suffers large redemptions causing the fund to exceed the quantitative limits in the investment fund definition. Such a fund would have to inform its investors that its units have not only ceased to be a QI but also can never recoup that status.

The deficiencies of the "investment fund" definition have long been known to fund managers, but it has become all the more important that such deficiencies be addressed given that the "investment fund" definition is used in an exemption from AMT and a proposed type of QI and that some of the restrictive elements currently found in the definition serve no discernible policy objective in the context of AMT, let alone in the context of LREs.

Below we discuss the "at all times" requirement with other examples and also present other specific concerns with the existing "investment fund" definition. We also make suggestions for improvement of the definition. These suggestions are guided by a belief that what is required is a definition that does not need to be modified every time it is used outside of the LRE rules. Rather, we recommend that the definition be moved to subsection 248(1) shorn of its "at all times" requirements. In this general definition, the relevant conditions – e.g., there are units that satisfy paragraph 4801(a) of the Regulations, the trust is resident in Canada, follows a reasonable policy of investment diversification, etc. – would only have to be met at a particular time, when the trust is being tested for investment fund status (the **General Definition**). Then, wherever the term is being used in a particular statutory context, the General Definition would be supplemented by a measurement period appropriate to that statutory context:

- *LRE rules* – here, the "investment fund" conditions from the General Definition would have to be met <u>at all times</u> since the relevant start dates currently found in the current definition in subsection 251.2(1) (subject to comments below on the measurement period in paragraph (a)).
- *AMT exemption in subparagraph 127.55(f)(ii)* – in determining whether a trust qualifies for this exemption in a particular taxation year, it would have to meet the conditions from the General Definition <u>throughout the taxation year</u>.
- *QI category for IFM-Managed Trusts* – In order to qualify for the "investment fund" component of this proposed new QI category, a trust should only be required to satisfy the General Definition <u>at the particular time</u> when it is being tested for QI status. This is consistent with the QI regime generally recognizing that investments can become or cease to be QIs part-way through a taxation year.[1]

[1] We will, however, be recommending in the aforementioned separate QI submission a measure for facilitating the orderly termination of QI status for an IFM-Managed Trust that ceases to be an "investment fund".

We believe a coordinated legislative approach is needed to locate in one place the essential elements of a General Definition of "investment fund," so that unduly restrictive features of the current definition are not imported into other regimes. This is not to say that the definition is ideal for LRE purposes. Below we discuss the deficiencies.

"Investment Fund" – Specific Concerns and Recommendations

In this section we highlight concerns with the definition of "investment fund" in subsection 251.2(1), particularly regarding the year of creation of the trust, the requirement that there be a distribution of units of the trust to the "public", the requirement for continuous real time monitoring of all elements of the definition, and the investment concentration test in clause (b)(vi)(D) of the definition. We make recommendations for legislative amendment.

Year of Creation

1. The condition in paragraph (a) of the investment fund definition must be satisfied at all times throughout the period that begins at the later of March 21, 2013, and the end of the calendar year in which the trust is created.

   a. Observations: For a trust created after March 21, 2013, it must have a class of units that are qualified for distribution to the public in accordance with Regulation 4801(a) in the same calendar year in which the trust is created. This is a practical issue for fund managers, especially if they are planning to launch a trust in December or January. If a trust is created in December in order to file a final prospectus in December, but units are not distributed to the public until January, the trust cannot meet the requirement in paragraph (a) that a class of units be distributed to the public at the time of the end of the first calendar year of the trust. Due to the vagaries of its creation and launch, such a trust is forever prevented from qualifying as an "investment fund". The timing of the initial distribution to the public is influenced by many factors, including factors outside the fund manager's control (for example, review by an applicable securities commission).

   b. Observations: For a trust created after March 21, 2013, draft legislation released by the Department of Finance on January 15, 2016, and ultimately enacted in the second 2016 budget bill, delayed the time from which the trust must comply with paragraph (a) of the investment fund definition from the time of the trust's creation to the end of the calendar year in which it was created.[2] This change appears to have inadvertently introduced a lacuna regarding whether a trust can be an investment fund between the time of its creation and the end of the calendar year in which it was created. We submit that from a policy perspective, a trust should be able to qualify as an investment fund once it complies with the conditions prescribed for paragraph 132(6)(c) without reference to regulation 4801(b).

      i. **Recommendations**:

         a. For a General Definition, remove the "at all times" requirement from paragraph (a). The appropriate measurement period during which paragraph (a) has to be satisfied would be addressed in each part of the Act where "investment fund" is used. See discussion above.

         b. For an amended investment fund definition to be used for purposes of the LRE rules (the LRE Definition),[3] amend paragraph (a) to remove references to the year in which the trust was created and instead require a trust to have complied continuously with the conditions prescribed for paragraph 132(6)(c) without reference to regulation 4801(b) since the first time it complied with such conditions.

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[2] This test was in paragraph (b) of the definition of "investment fund" in proposals enacted as part of the second 2014 budget bill, and was moved to paragraph (a) in the 2016 proposals.

[3] If a General Definition were to be added to subsection 248(1), it may well be that the LRE Definition ends up being a definition of "investment fund" that contains 'reading rules' that refer to the term as defined in the General Definition but add additional conditions for LRE purposes only. For ease of discussion, however, our suggestions for changes to be made to the LRE Definition are presented as amendments to the existing definition as if it were to continue to be fully articulated in subsection 251.2(1).

Distribution to the Public

1. Paragraph (a) of the investment fund definition requires that, at all times throughout the period, the trust have a class of units outstanding that complies with the conditions prescribed for purposes of paragraph 132(6)(c) without reference to Regulation 4801(b). This refers to Regulation 4801(a) which, generally requires that there has been a distribution of units to the "public" (pursuant to clause (a)(i)(A) or subparagraph (a)(ii) and Regulation 4803(2)).

   a. **Observations**: The term "public" is not defined in the Act. In such circumstance, reference is given to the meaning in broader commercial law, which here should be provincial securities law. We submit the term "public" in provincial securities law may not be entirely clear or consistent. One potential issue is whether a distribution of units by a bottom fund to a top fund or top funds is a distribution to the public.

      ii. **Recommendation**: Amend Regulation 4803 to insert a deeming rule that a trust is deemed to have made a lawful distribution to the public when it distributes units to one or more other trusts or corporations that themselves have made a lawful distribution of units or shares to the public.

Continuous Compliance

1. Both paragraph (a) and paragraph (b) of the investment fund definition require compliance with their conditions at all times throughout the applicable period.

   a. **Observations**: If a trust breaches any of the conditions in the definition of investment fund, even momentarily, investment fund status is lost forever. There is no possibility of a fresh start. For example, suppose a top fund trust (with $12.5 million of assets) invests $1.5 million (12% of its assets) in a bottom fund that is a non-resident trust with $10 million of assets, thereby holding 15% of the bottom fund; however, as a result of redemptions by other investors the bottom fund's asset size shrinks to $7.4 million a day before the top fund also redeems its bottom fund units. The top fund trust would have breached the clause (b)(vi)(D) concentration test by holding 20.3% of the units of the bottom fund for one day and could never henceforth qualify as an investment fund. It is submitted that whatever policy concerns may have led to an "at all times" requirement in the context of the LRE rules (such as not wanting to grant the exemption to investment funds housed within trusts that had a prior existence as trusts that conducted a business) have no bearing in the context of AMT, which is determined anew each year depending on the relevant facts (such as utilization of tax preferences) in that year, or in the context of the QI regime, where it is status of an investment at specific times that is most relevant.

      iii. **Recommendations**:

         a. For a General Definition, remove the "at all times" requirement from paragraph (b). The appropriate measurement period during which paragraph (b) has to be satisfied would be addressed in each part of the Act where "investment fund" is used.

         b. In the LRE Definition, the "at all times" requirement could be kept, but for AMT the measurement period during which the paragraph (b) conditions have to be met should be the relevant taxation year and the period during which such conditions have to be met for the new QI category is a particular time when QI status of a trust is being tested.

Clause (b)(vi)(D) Concentration Test

1. Clause (b)(vi)(D) of the investment fund definition requires that the trust not hold more than 20 percent of any class of securities of a person (other than an investment fund or a mutual fund corporation meeting certain conditions); however, there is an exception to the 20 percent test that applies if such securities are equities with a fair market value of less than 10 percent of the equity value of the person or the securities are liabilities with a fair market value of less than 10 percent of the value of all liabilities of the person.

   a. **Observations**: Subsection 251.2(1) defines, for section 251.2, the term "person" to include a partnership. That means that a trust can breach the clause (b)(vi)(D) concentration test by holding more than 20% of a class of securities of a partnership. This is a significant risk for fund-on-fund structures, where the top fund is a trust and the bottom fund is a partnership that then invests in a portfolio of securities.

i. **Recommendation**: Amend clause (b)(vi)(D) to permit compliance with the concentration test on the basis of looking-through a partnership. This change would be made in the proposed General Definition and would apply for LRE and Non-LRE Uses.

b. **Observations**: In practice, a fund is most likely to breach the clause (b)(vi)(D) concentration test by investing in a bottom fund that is a partnership, a Canadian-resident trust that is not an investment fund, or a non-resident trust or corporation. A non-resident trust or corporation cannot qualify as an investment fund. Prior to the proposals released in 2016, the definition of "portfolio investment fund" employed the definition of "portfolio investment entity" in subsection 122.1 (the SIFT rules), being an entity that does not hold any non-portfolio property. In determining whether an entity holds non-portfolio property, an interest in a portfolio investment entity is excluded, and for this purpose an entity can qualify as a portfolio investment entity regardless of its legal form or residence.

ii. **Recommendation**: Amend the parenthetical exception in clause (D) to an entity that would be an investment fund if the entity were a trust and the definition were read without reference to paragraph (a) or subparagraph (b)(i). This change would be made in the proposed General Definition and would apply for LRE and Non-LRE Uses.

c. **Observations**: As noted above, the conditions in paragraph (b) of the investment fund definition must be complied with at all times throughout the applicable period. Monitoring the clause (b)(vi)(D) concentration test is challenging in practice because it requires portfolio management data that are not normally available in fund accounting systems. In particular, the denominator for the 20% test is the value of all securities of the particular class of securities that is held. The denominator for the 10% test is the fair market value of all equity securities or liabilities of the person. For example, fund accounting data include the number and value of securities of a particular class held by the trust at a particular point in time, but fund accounting data generally do not include the number or value of securities of that class that are outstanding at that point in time or the fair market value of all equity securities or liabilities of the issuer at the point in time.

Also, the investment concentration test in NI 81-102 for investments in public securities generally applies at the of purchase, not continuously. As a result, existing compliance systems are typically built to apply at the time of purchase.

iii. **Recommendation**: Amend the clause (b)(vi)(D) test to apply at the time of an acquisition of a security. This change would be made in the proposed General Definition and would apply for LRE and Non-LRE Uses.

II. Section 127.55 – Alternative Minimum Tax Exemptions

While adjustments to the subsection 251.2(1) definition would significantly improve the functionality of the 'investment fund' category for AMT purposes, the broader framework of AMT-exempt trusts in paragraph 127.55(f) also presents issues that merit independent consideration. Accordingly, in this section we note certain concerns with the AMT exception in subparagraph 127.55(f) (iii) and recommend legislative amendment.

Subparagraph 127.55(f)(iii)

1. Subparagraph 127.55(f)(iii) provides that section 127.5 does not apply to a trust that satisfies the conditions in clauses 127.55(f)(iii)(A)-(D).

a. **Observations**: Clause (A) requires that all of the beneficiaries of the trust be any combination of persons exempt from tax under Division F or trusts described in subparagraph 127.55(f)(iii).

iv. **Recommendation**: Amend clause (A) to make it clear that the scope of 'good' beneficiaries includes (1) persons to whom section 127.5 does not apply, such as corporations (whether taxable or not), and (2) partnerships all of whose members are exempt from tax under Division E.1.

b. Observations: Clause (B) requires that no person (other than a person described in subclause (A)(I) or (II)) can be added as a beneficiary of a trust. Prior to the introduction of this clause, most trusts will not have had an explicit requirement in their declarations of trust that their beneficiaries are limited to the types of persons set out. In addition, even if a declaration of trust included such requirement, it is conceivable that a 'bad' person could become a beneficiary before the trustee of the trust becomes aware. For example, suppose a fund's declaration of trust provides that only trusts governed by RRSPs are eligible to be beneficiaries, and if a unit is acquired by a person that is not an RRSP, the unit will be redeemed at the time of that acquisition. And then suppose that the annuitant of an RRSP that held units dies and ownership of the units passes to the estate. In that scenario, there might be a delay before the manager or trustee is informed of the annuitant's death and can redeem the units.

v. **Recommendation**: Amend clause (B) to require that if a person not described in subclause (A)(I) or (II) became a beneficiary, the person ceased to be a beneficiary at or before the time the trustee reasonably should have been aware that the person was not described in subclause (A)(I) or (II).

c. Observations: Clause (D) requires that the trust be "irrevocable". This is a term not used anywhere else in the Act. Under trust law, a trust is revocable if the settlor expressly retained a power of revocation, being the power to recover the trust assets and do with them as he or she will.

One example that gives rise to interpretive uncertainty here is where the settlor is also a beneficiary and beneficiaries have the right to redeem their interests. For example, the settlor might settle a paragraph 108(2)(a) unit trust for $10 and thereby become a beneficiary holding one unit of the trust worth $10. Another such example is that it is common for commercial unit trusts to be terminable by a meeting of the unitholders upon passing a special resolution.

We submit that a beneficiary's right of redemption or the right of all beneficiaries to terminate a trust is not the same thing as a right of revocation, but whether this is a complete answer in the context of subparagraph 127.55(f)(iii) where the settlor is also a beneficiary may be seen by others as open to debate, particularly since the use of "irrevocable" in the Act is novel and the policy reason for its inclusion is unclear.

vi. **Recommendation**: We submit that the clause (C) requirement that all interests in the trust be fixed interests as defined in subsection 94(1), combined with the clause (A) and (B) requirements about permissible beneficiaries, are sufficient to address policy concerns about a settlor inappropriately receiving assets from a trust. Accordingly, we recommend removing clause (D).

Conclusion

SIMA respectfully urges the Department of Finance to adopt a coordinated legislative approach that relocates a streamlined, point-in-time General Definition of "investment fund" to subsection 248(1), calibrates any measurement period to the specific policy objective at issue. This would preserve integrity in the LRE context while ensuring the AMT exemption and QI regime operate predictably and practicably.

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We would welcome the opportunity to discuss these recommendations and to assist with draft legislative language and would be pleased to provide further information or answer any questions you may have. Please feel free to contact me by email at jbaillargeon@sima-amvi.ca or, by phone 416-309-2323.

Yours sincerely,

THE SECURITIES AND INVESTMENT MANAGEMENT ASSOCIATION

Josée Baillargeon

By: Josée Baillargeon
Director, Taxation Policy

cc: Andrew Donelle, Senior Director, Deferred Income Plans, Tax Legislation Division
(Andrew.Donelle@fin.gc.ca)
Zachary Fentiman, Senior Tax Policy Officer, Tax Legislation Division
(Zachary.Fentiman@fin.gc.ca)
Patrick Egit, Senior Tax Policy Officer, Tax Legislation Division
(Patrick.Egit@fin.gc.ca)

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Delivered By Email: alexandra.maclean@canada.ca

Ms. Alexandra MacLean
Director, Tax Legislation
Tax Policy Division
Finance Canada
90 Elgin Street
Ottawa, ON
K1A 0G5

Dear Ms. MacLean:

RE: Legislative Proposals on the Tax Rules for Certain Trusts and their Beneficiaries, released on January 15, 2016

We are writing to provide our comments on the above-noted draft legislative proposals to amend the provisions of the *Income Tax Act* (Canada) (the "ITA") relating to the loss restriction event ("LRE") rules applicable to trusts. We acknowledge the helpful discussions that we have had with your department regarding the proposals and the policy objectives.

Unless otherwise noted, all references are to the ITA as it is proposed to be amended by the draft legislative proposals.

We believe that some of our comments can be addressed by making changes to the Explanatory Notes in order to give guidance to the Canada Revenue Agency as to the intention of the department. To give effect to our other comments, we submit that amendments to the draft legislation will be required.

Definition of Investment Fund

1. *Paragraph (a) of the definition does not accommodate a trust formed in a calendar year that does not distribute units to the public in the same calendar year.*

Paragraph (a) of the proposed definition of "investment fund" requires that, at all times throughout the period that begins at the later of March 21, 2013 and the end of the calendar year in which it is created and that ends at the time that investment fund status is to be determined, the trust has a class of units outstanding that complies with the conditions prescribed for the purposes of paragraph 132(6)(c) determined without reference to paragraph 4801(b) of the Income Tax Regulations ("ITR").

Paragraph 4801(a) of the ITR requires that either (i) there has been a lawful distribution to the public of units of the trust and no prospectus or similar document was required, or (ii) a class of units of the trust is "qualified for distribution to the public". In order for a class of units to satisfy the conditions of the definition of "qualified for distribution to the public" in subsection 4803(2) of the ITR at a particular time, a prospectus, registration statement or similar document must have been filed with, and, where required by law, accepted for filing by, a public authority in Canada pursuant to and in accordance with the law of Canada or of any province <u>and</u> there must have been a lawful distribution to the public of units of that class in accordance with that document.

In the case of a trust formed near the end of the year, the issuance of units to the manager as seed capital is unlikely to be a distribution to the "public". If units are not issued to the public before the end of the calendar year in which the trust is formed, whether or not pursuant to a prospectus, the trust can never meet the condition in paragraph (a) of the proposed definition of "investment fund". We understand that this result was not intended.

We submit that paragraph (a) could be amended to refer to the "later of March 21, 2013 and [a specified time after] the end of the calendar year in which it is created…" The specified time could be six months or 90 days.

2. *Paragraphs (a) and (b) of the definition require that the conditions therein be satisfied "at all times" throughout the period. Thus, if at any time in the period, any condition in paragraph (b) is not satisfied, the trust can never again be an "investment fund".*

We submit that there is no policy reason for disqualifying a trust that goes "offside" from ever being an investment fund in the future. In our view, if a trust were to cease to qualify as an investment fund because it failed to meet one of the conditions set out in paragraph (b) of the definition and subsequently experienced a LRE, a fresh start would be appropriate. If the trust experiences a LRE, it would have a tax year end and its losses could not be carried forward. The mischief that the LRE rules seek to prevent would be prevented.

We submit that consideration should be given to a "fresh start" rule that would commence immediately following the last LRE. The following language could be considered for paragraph (b):

> "at all times throughout the period that begins at the latest of (x) March 21, 2013, (y) the time of its creation, and (z) the last time, if any, at which the trust was subject to a loss restriction event, and that ends at that time, the trust…"

3. *Clause (b)(i)(D) of the definition refers to deriving value from a "diversified portfolio of securities (as defined in subsection 122.1(1))." This phrase is unclear.*

As a general comment, because paragraph (b) of the definition contains very specific rules and because of the consequences of failing to meet any of the rules at any time, it is submitted that the rules must be clear.

Meaning of Diversified Portfolio

It is not clear how the term "diversified" is to be interpreted. The number of securities required for proper diversification is a subject of debate. It is not clear to us that a country fund, sector fund or commodities fund, for example, would be considered to be a diversified portfolio because even though such a fund could own many securities, those securities are concentrated in a geographic area, industry or commodity.

Even if there were agreement as to what constitutes a "diversified portfolio", there are situations in which the securities that a trust owns may not be a diversified portfolio:

(a) In a start-up scenario, as the trust first begins to invest in securities, it may have 85% of its assets in cash and 15% in securities of, say, two issuers. It may therefore not derive all or substantially all its value (i.e., 90%) from cash and a "diversified" portfolio of securities since securities of two issuers is unlikely to be a diversified portfolio.

(b) Where a manager believes that equity or bond markets, as applicable, are overvalued, the manager may liquidate a substantial portion of the trust's portfolio to hold cash but continue to hold a few securities because they are illiquid. Those securities may represent more than 10% of the value of the trust's assets and not be a diversified portfolio.

In our submission, the difficulty arises because the definition requires one to test whether the trust has a diversified portfolio at every point in time and, at a particular time, the portfolio may not, in fact, be diversified even though the manager is endeavouring to follow a reasonable policy of diversification.

As we discussed in our conversation with the department, we think that the "diversified portfolio" test should be replaced by a test that requires the trust to "follow a reasonable policy of investment diversification". The two scenarios described above should come within this test because, in assessing whether a fund is diversified, the cash and other assets of a fund would be considered together with the securities. This test will also allow for taking into account the context in which the fund is being managed (e.g., the start-up phase). The test that we propose is that used in clause (b)(i)(B) of the definition of "excluded property" in subsection 207.01(1) which was drafted with the same objective in mind, to define a *bona fide* investment fund. The Explanatory Notes relating to the definition of "excluded property" state:

> "This latter rule is intended to be a reasonably flexible test that will avoid both the risk of disqualifying a fund for minor breaches of, for example, a percentage test, and the need for potentially complex carve-outs and timing rules."

Accordingly, we submit that clause (b)(i)(D) should be amended to delete the words "a diversified portfolio of" and that paragraph (b)(iv) be amended to read "limits its undertaking to the investing of its funds in property and follows a reasonable policy of investment diversification".

Meaning of "Security" and Derivatives

Subparagraph (b)(i) of the definition requires that the trust "derives all or substantially all its value, directly or indirectly" from the enumerated properties. We understand that the use of the term "indirectly" is not intended to be restricted to situations where exposure to the enumerated properties is derived through "indirect" ownership (such as a "fund-on-fund" structure) but also extends to value derived indirectly through derivative contracts that provide exposure to the enumerated properties.

The enumerated properties do not include foreign exchange rates or interest rates so that a derivative that provides exposure to foreign exchange rates or interest rates would not be a "good" asset unless the derivative itself could be considered to be a "security" as defined in subsection 122.1(1). It is not clear that such definition includes certain derivatives because the derivatives are in the nature of obligations to perform under executory contracts.

In order that there is no doubt that derivatives are "good" assets, we submit that it would be desirable to add as new clause (b)(i)(E) the following:

> options, interests, rights and forward and futures agreements in respect of property described in any of clauses (A) to (D) or this clause, and agreements under which obligations are derived from foreign exchange rates, from interest rates, from the price of property described in any of those clauses, from payments made in respect of such a property by its issuer to holders of the property, or from an index reflecting a composite measure of such rates, prices or payments, whether or not the agreement creates any rights in or obligations regarding the referenced property itself.

The foregoing is analogous to paragraph (f) of the definition of "qualified investment" in subsection 115.2(1) with the addition of the reference to "foreign exchange rates". It assumes that the changes to clause (b)(i)(D) and paragraph (b)(iv) noted above are made.

4. *The description in subparagraph (b)(vi) of the definition of the property that the trust may not hold raises a number of issues.*

Property Used in Carrying on a Business

Clause (b)(vi)(A) provides that the trust may not hold property that the trust, or a person with which the trust does not deal at arm's length, uses in carrying on a business.

In light of the requirement that the trust must limit its undertaking to the investing of its funds in property, we question the need for a requirement that the trust not hold property used in carrying on a business. In the income trust structures that existed before the enactment of the SIFT rules, the trust that qualified as a mutual fund trust at the “top” of the structure was not considered to carry on a business because it held (i) shares and notes of a corporation (i.e., investments); (ii) shares and units of a unit trust (i.e., investments); or (iii) units of a limited partnership (and section 253.1 applied to deem the trust not to thereby carry on the business of the partnership). Since section 253.1 will be amended to apply to the definition of “investment fund” it is not obvious how the additional restriction is relevant in excluding former income trusts from the definition of investment fund which we understand is one of the Department’s policy objectives.

We submit that clause (b)(vi)(A) be amended to provide that the trust may not hold “property that a person with which the trust does not deal at arm's length uses in carrying on a business”.

Resource Property and Real Property

With respect to clause (b)(vi)(C), we note that there is no definition of “resource property” for the purposes of the ITA. You may wish to use the terms “Canadian resource property” and “foreign resource property”.

With respect to clauses (b)(vi)(B) and (C), we submit that the provisions of the ITA are inconsistent in determining whether a beneficiary of a trust or member of a partnership “holds” property, or an interest in property, that is owned by a trust or partnership. For example, in the definition of “Canadian resource property” in subsection 66(15), paragraph (g) excludes “a right or interest that a taxpayer has because the taxpayer is a beneficiary under a trust or a member of a partnership”. The foregoing is particularly significant in determining whether an investment fund may hold securities of a trust that holds real property (i.e., a REIT). We understand that there is no intention to exclude from the definition of investment fund a trust that holds a portfolio of units of REITs.

We submit that language comparable to that in the definition of “Canadian resource property” should be added to clauses (b)(vi)(B) and (C) such as “and for greater certainty, excludes a right or interest that a taxpayer has because the taxpayer is a beneficiary under a trust or a member of a partnership”.

5. *The “carve out” from the 20% ownership test in clause (b)(vi)(D) of the definition for investment funds is too narrow.*

Clause (b)(vi)(D) provides that the trust may not hold more than 20% of the securities of any class of securities of a person (other than an investment fund) subject to the “saving rules” in sub-clauses (b)(vi)(D)(I) and (II).

The exception to the 20% rule for holdings in an investment fund does not apply, for example, to an investment in a corporation, whether resident or non-resident, or to an investment in a non-resident trust or a partnership. This is so even though the corporation, non-resident trust or partnership could, if it were a resident trust, meet the conditions in paragraph (b).

It is common for a Canadian trust, as it is a flow-through entity, to be used as a “feeder fund” that invests in a corporation (such as a Luxembourg SICAV), referred to as a “master fund”, in order to provide Canadians with access to a portfolio managed by a non-resident manager. Typically the Canadian feeder will subscribe for a separate class or series of shares (that may be denominated in CAD or that may be hedged to CAD). In start-up scenarios, the Canadian feeder may own 100% of a class or series that represents more than 10% of the equity value of the master fund.

Similarly, a Canadian trust may gain exposure to foreign securities by way of fund-on-fund investing through a foreign collective investment vehicle that is organized as a trust in a foreign jurisdiction. While such a foreign trust may resemble an "investment fund" in most respects, it would not be resident in Canada such that the Canadian trust's investment in the foreign trust would not qualify for the carve-out from the 20% ownership test.

It is submitted that, for the purposes of the LRE rules, the legal form and residence of the master fund should not matter if the master fund would otherwise meet the requirements to be an investment fund.

Additional Comments

1. *The periods for extended filings in proposed subsection 251.2(7) should also apply to subsection 221(2) of the ITR.*

Subsection 221(2) of the ITR provides that "where in any taxation year a reporting person (other than a registered investment) claims that a share of its capital stock issued by it, or an interest as a beneficiary under it, is a qualified investment under section 146, 146.1, 146.3, 204, 205 or 207.01 of the Act, the reporting person shall, in respect of the year and within 90 days after the end of the year, make an information return in prescribed form." "Reporting person" is defined to include a mutual fund trust and certain other trusts.

2. *Interaction of LRE year end and Subsection 132.11(4)*

Although our submission primarily addresses the definition of "investment fund", we note that there is an anomalous result that requires correction if a mutual fund trust that is not an investment fund, and which has a December 15 year end, experiences an LRE in the period December 16 to December 31, say December 29. It will have a stub year for December 16 to December 28. If it makes an amount payable in the period December 16 to December 28 with the intention of reducing its income for the stub period to nil under 104(6), subsection 132.11(4) appears to deem the amount to have been payable on December 15 (i.e., before the beginning of the stub year and 104(6)(b)(i) only allows a deduction for an amount "as became payable in the year to a beneficiary").

We believe that the issue could be addressed if subsection 132.11(4) were amended to read as follows:

> Notwithstanding subsection 104(24), for the purposes of subsections (5) and (6) and 104(6) and (13) and paragraph (i) of the definition "disposition" in subsection 248(1) each amount that is paid, or that becomes payable, by a trust to a beneficiary after the end of a particular taxation year of the trust that ends on December 15 of a calendar year because of subsection (1) and before the end of that calendar year, is deemed to have been paid or to have become payable, as the case may be, to the beneficiary at the end of the particular year and not at any other time <u>unless the trust designates otherwise in its return of income for the particular taxation year.</u>

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

Yours sincerely,

THE INVESTMENT FUNDS INSTITUTE OF CANADA

By: Ralf Hensel
General Counsel, Corporate Secretary and Vice President, Policy

Cc: Grant Nash, grant.nash@fin.gc.ca