

---

# Mutual Fund and Segregated Fund Flowthrough Tax Rules: Resolving the Inconsistencies

Kathleen C. Young\*

---

## PRÉCIS

La forme juridique des fonds communs de placement et des fonds réservés est différente, mais leur fondement économique est identique. Néanmoins, la Loi de l'impôt sur le revenu leur réserve un traitement différent. Ces différences sont significatives et peuvent désavantager la personne qui investit dans des fonds communs de placement. Dans cet article, l'auteure examine les règles qui régissent le traitement fiscal des fiducies de fonds commun de placement, des sociétés d'investissement à capital variable et des fonds réservés. Elle propose une nouvelle méthode qui, si elle est retenue, permettrait à l'administration fiscale de mettre l'accent sur un objectif global de transparence fiscale et de traitement équitable pour tous les contribuables.

L'adoption de la méthode suggérée pour les fonds communs de placement et, en définitive, les autres fonds de placement permettrait, entre autres, un rapprochement parfait des gains et des pertes en capital entre un fonds et ses investisseurs. Cette méthode pourrait être retenue sans perte de recettes nettes pour le gouvernement et sans fardeau administratif substantiel pour le secteur des fonds communs de placement, et elle permettrait aux investisseurs et à l'administration fiscale de réaliser des économies.

À l'heure actuelle, les organismes de réglementation s'intéressent à l'harmonisation des règles et des règlements qui régissent les produits financiers semblables. L'administration fiscale ne devrait pas moins se préoccuper des incohérences dans l'imposition de ces produits pour que les investisseurs soient en mesure de choisir les produits, à la lumière des mérites de la stratégie de placement sous-jacente plutôt qu'en fonction des conséquences fiscales.

## ABSTRACT

Mutual funds and segregated funds differ in legal form, but they are identical in economic substance. Nevertheless, the Income Tax Act treats the two types of funds differently. The differences are significant and can be disadvantageous to mutual fund investors. In this paper, the author examines the rules that govern the tax treatment of

---

\* A tax and financial consultant to the mutual fund industry based in Toronto, Ontario. The author wishes to thank Jillian Welch of McCarthy Tétrault LLP and Hugh Chasmar of Deloitte & Touche LLP for their helpful comments. Any errors or omissions are, of course, the sole responsibility of the author.

mutual fund trusts, mutual fund corporations, and segregated funds. She proposes a new approach that, if adopted, would allow the tax authorities to focus on an overall objective of fiscal transparency and equal treatment for all taxpayers.

The adoption of the approach suggested herein for mutual funds, and ultimately for other investment funds, would, among other benefits, permit the perfect matching of capital gains and losses between a fund and its investors. This approach could be adopted with no net loss of revenue to the government and no substantial administrative burden to the mutual fund industry, and it would enable both investors and tax authorities to realize administrative efficiencies.

At present, securities regulators are concerned with harmonizing the rules and regulations that govern similar financial products. Tax authorities should be no less concerned with remedying the inconsistencies in the taxation of such products so that the investing public will be able to choose products on the merits of the underlying investment strategy rather than on the basis of tax implications.

**KEYWORDS:** MUTUAL FUNDS ■ SEGREGATED FUNDS ■ SUBSTANCE OVER FORM ■ CONSISTENCY ■ INVESTMENT INCOME ■ TAX SYSTEMS

---

## CONTENTS

Introduction	886
The Mutual Fund and the Segregated Fund Industries	887
Background	887
The Structures of the Funds	890
Mutual Funds	890
Segregated Funds	890
Regulatory Harmonization	891
Establishing a Policy Framework for Tax Reform	893
Legal Structures: Trust, Contract, and Corporation	893
Trust	893
Contract	894
Corporation	895
Tax Law	896
Fiscal Transparency: The Passthrough, Conduit, and Imputation Approaches	896
The Investor's Perspective: Tax Efficiency	899
Inconsistencies in the Flowthrough Rules	900
Flowthrough of Capital Gains	901
Segregated Funds	901
Mutual Funds	904
The Problems	907
Recommendations	910
Flowthrough of Capital Losses	910
Segregated Funds	911
Mutual Funds	911
The Problem	912
Recommendation	913
Flowthrough of Income	913
Segregated Funds and Mutual Fund Trusts	913
Mutual Fund Corporations	914

The Problems	914
Recommendation	915
Allocation Methods	915
Segregated Funds	916
Mutual Funds	917
The Problem	918
Recommendation	921
Tax Policy Considerations	921
Equity	921
Neutrality	922
Protecting the Fisc	922
Economic Efficiency	922
Administrative Complexity and Cost	922
Conclusion	923

---

## INTRODUCTION

Mutual funds and segregated funds are investment pools that are sold to the public on a retail basis. They allow investors<sup>1</sup> to pool their money and invest in a large and diversified portfolio of securities without having to purchase the securities directly. The funds provide many advantages over direct investing; in particular, they allow small investors a level of diversification generally available only to wealthy investors who have substantial amounts of money.

Mutual funds and segregated funds coexist in the investment market in three different legal forms; they are subject to two different regulatory regimes and three different sets of tax rules. Investors in both types of funds are purchasing a diversified investment portfolio; their choice of investment vehicle, though, has a significant impact on their tax position from year to year.

One author has noted that the tax rules for segregated funds, which were adopted in 1969 and amended in 1978, were “intended to establish a level playing field with the mutual fund industry for investment products that were substantially similar in nature.”<sup>2</sup> The rules had “the objective of taxing such funds in the same way as if the funds were invested in an unincorporated mutual fund [trust].”<sup>3</sup> However, it is my belief that the rules that were adopted put segregated funds in a much more favourable tax position than mutual funds. The Income Tax Act<sup>4</sup> fails,

---

1 In this paper, I generally use the generic term “investors” to refer to contract holders, unitholders, and shareholders of segregated funds, mutual fund trusts, and mutual fund corporations, respectively. The specific term will be evident from the context in which the generic term is used.

2 William J. Strain, “Taxation of Life Insurance” (1995) vol. 43, no. 5 *Canadian Tax Journal* 1506-46, at 1519.

3 *Ibid.*, at 1525.

4 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this paper are to the Act.

in the words of another author, “to apply a coherent and consistent treatment to legal entities, economic claims, and cash flows that differ in form but that are identical in substance.”<sup>5</sup>

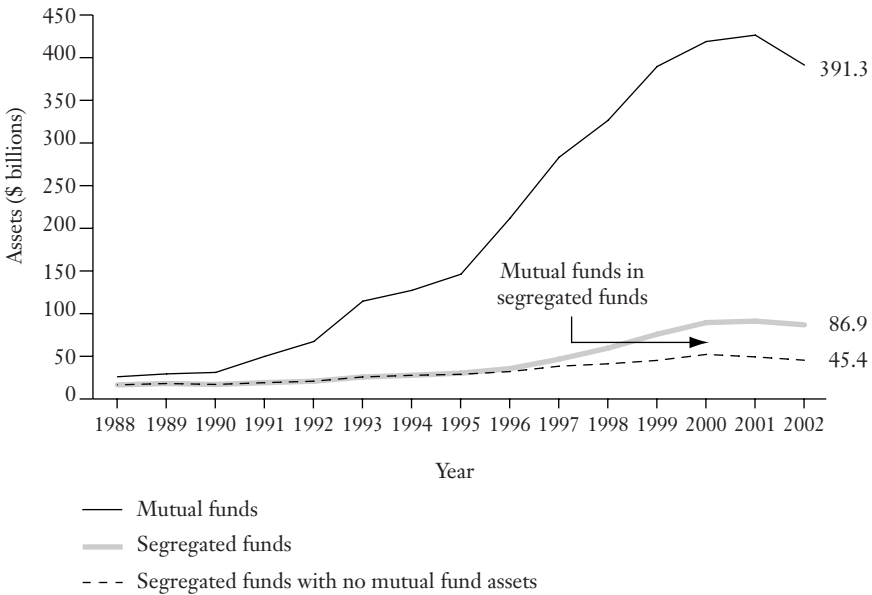
For the past several years, the mutual fund industry has attempted to correct the inconsistencies and thereby place mutual funds on the same footing as segregated funds. It has done this by means of ad hoc applications for income tax rulings and submissions to the Department of Finance, only to have its attempts fail because of reporting requirements or legislative changes. In this paper, I will examine the tax rules for the flowthrough of investment income for each of a mutual fund trust, a mutual fund corporation,<sup>6</sup> and a segregated fund. I will show the need for a comprehensive approach to investment fund taxation, and I will make the case for a consistent, efficient, and equitable set of flowthrough tax rules applicable to both types of funds.

## THE MUTUAL FUND AND THE SEGREGATED FUND INDUSTRIES

### Background

Throughout the 1960s, 1970s, and 1980s, the mutual fund and the segregated fund industries developed along parallel but separate courses in Canada. Mutual fund management was not considered part of the traditional financial services sector, which comprised the “four pillars” of banking, securities, trusts, and insurance. Today, however, the mutual fund industry may be thought of as a fifth pillar because of its importance as a financial intermediary in the economy, though some may consider it more closely aligned with the securities industry. The mutual fund industry has grown from just over \$25 billion in assets under management in 1988 to more than \$391 billion by the end of 2002. During the same period segregated funds grew

- 
- 5 Paul D. Hayward, “Income Trusts: A ‘Tax-Efficient’ Product or Product of Tax Inefficiency?” (2002) vol. 50, no. 5 *Canadian Tax Journal* 1529-69, at 1546. Hayward’s paper focuses on the earning of business income through a trust versus a corporation. My paper focuses on the earning of investment income through a pooled arrangement, whatever its legal form. See also Paul D. Hayward, “Monetization, Realization, and Statutory Interpretation” (2003) vol. 51, no. 5 *Canadian Tax Journal* 1761-1824, at the abstract, where he reiterates his thesis of the “Act’s failure to treat equivalent economic positions consistently.”
  - 6 Historically, mutual funds were primarily corporations, but most old mutual funds corporations converted to trusts in the 1990s using the mutual fund reorganization rules in section 132.2 of the Act. Only \$9 billion of assets are in single-class unconverted or specialty mutual fund corporations. Trusts are generally recognized to be more tax-efficient than corporations. The majority of mutual funds today are trusts, and they account for over 94 percent, or \$426 billion, of the total \$451 billion of assets managed in the mutual fund industry. Newer corporations are usually formed as multi-class, multi-investment-objective corporations for the purpose of using the section 51 corporate reorganization rule, which allows tax-deferred movement between classes and therefore, in the mutual fund’s case, between investment objectives. Multi-class corporations contain \$16 billion, or 3.6 percent, of the \$451 billion in managed assets. All fund statistics are from the Investment Funds Institute of Canada’s (IFIC) member statistics as of January 2004.

**FIGURE 1 Assets Under Management**

Source: Investment Funds Institute of Canada, “Historical Overview, Canadian Mutual Fund Industry” (available on the IFIC Web site at <http://www.ific.ca/eng/frames.asp?11-Statistics>).

more slowly, from \$16 billion to more than \$86 billion in assets under management (see figure 1).<sup>7</sup>

The deregulation of the financial services sector, which began in the late 1980s, has resulted in a blurring of the clear distinctions between the “pillars” in the last decade. Many banks now own large brokerages and trust companies, and all banks have their own mutual fund management arms. Insurance companies, in turn, own trust and brokerage operations, but there are restrictions on the merging of banks and insurance companies. Traditionally, segregated funds were the insurance companies’ equivalent of mutual funds, but insurance companies also have now purchased or started their own mutual fund management companies.

In the mid-1990s, segregated funds began to invest in mutual funds—a development that knocked the two types of products off their parallel courses and brought

7 See Investment Funds Institute of Canada, “Historical Overview, Canadian Mutual Fund Industry,” at <http://www.ific.ca/eng/frames.asp?11=Statistics>. Mutual fund assets under management at the end of 2003 were \$438.9 billion, reflecting the recovery in 2003 from the market declines in 2002. See also Canadian Life and Health Insurance Association, *Canadian Life and Health Insurance Facts*, annual editions from 1989 to 2003 (Toronto: Canadian Life and Health Insurance Association).

them together for the first time. In 1996, Manulife Financial (Manulife) introduced its guaranteed investment funds (GIFs). The GIF product is a segregated fund that invests solely in mutual funds, allowing Manulife to offer an insurance product without providing the active investment management component. Mutual fund companies have responded by offering segregated funds that invest in the mutual funds they manage, with insurance company partners effectively providing only the life insurance component of the product.<sup>8</sup> By December 2002, of \$86 billion of assets in segregated funds, over \$41 billion was invested in mutual funds.<sup>9</sup>

The tax rules that govern mutual funds and segregated funds today were developed in the 1970s or earlier, when both industries were fledglings and between them had barely \$10 billion in assets under management. Few revisions of any significance have occurred since then; yet these rules have a tremendous impact on millions of investors.

Until the GIF and other fund-on-fund products were introduced, neither the mutual fund nor the segregated fund industry took particular notice of or interest in the tax aspects of the other's products. This lack of knowledge has contributed to the inconsistencies in the tax rules for both industries. Articles and conference reports from the 1970s through the late 1990s addressed the taxation of one type of fund or the other, but not both. The only cross-reference was an acknowledgment that segregated funds were taxed in an equivalent manner to mutual funds.<sup>10</sup> Not until 1999 were the two types of funds actually compared in detail, in a paper that offered an excellent description of tax and legal issues but no analysis of what the differences meant to the investor.<sup>11</sup> I will attempt to provide that analysis here by showing the effects of the inconsistent rules on the taxation of investors.

---

8 Funds sponsored by insurance companies generally handle aspects of the fund such as administration, distribution, marketing, and insurance, with investment management provided to the underlying mutual fund by its respective manager. Funds sponsored by a mutual fund manager handle all fund details, with the exception of the insurance "wrapper."

9 See *Canadian Life and Health Insurance Facts*, supra note 7.

10 Strain, supra note 2; Fred F.J. Borgmann, *Canadian Insurance Taxation* (Markham, ON: Butterworths, 1998), 202; Ronald C. Knechtel, "Federal Income Taxation of Life Insurance Policyholders Under the Present Law and Under the Current Proposals," in *Report of Proceedings of the Twenty-Ninth Tax Conference, 1977* Conference Report (Toronto: Canadian Tax Foundation, 1978), 612-27, at 624; and Ronald C. Knechtel, "Taxation of the Life Insurance Industry: The 1978 Tax Reform" (1980) vol. 28, no. 1 *Canadian Tax Journal* 9-31, at 29. The assumption that the taxation of segregated funds is equivalent to that of mutual funds is attributed to the objective, stated by the Department of Finance in announcing changes to the 1968 Budget, that they be taxed "in the same way as . . . an unincorporated mutual fund." See Knechtel, "Federal Income Taxation of Life Insurance Policyholders," supra, at 624.

11 See Philip Friedlan, "Segregated Funds vs. Mutual Funds, Selected Legal and Tax Aspects," in *Second Annual Innovative Uses of Insurance*, Federated Press Conference, Toronto, February 25-26, 1999 (Toronto: Federated Press, 1999), section 3.1.

## The Structures of the Funds

### *Mutual Funds*

Mutual funds are diversified investment portfolios that are structured either as trusts or as corporations. When the trust form is used, the mutual fund management corporation usually acts as the trustee<sup>12</sup> of the fund, and a declaration of trust serves as the constating document of the fund. Mutual fund corporations are formed by articles of incorporation; a board of directors oversees the management of the fund by a management corporation. Mutual funds are subdivided into trust units or corporate shares whose value fluctuates daily on the basis of the pool of assets in the fund. Generally, investors have the right to redeem their investments in a mutual fund, on demand to the mutual fund manager,<sup>13</sup> at the net asset value of the units or shares.

Investors have an interest only in the units or shares of the fund; they do not have a direct claim on the underlying assets. In a mutual fund that is structured as a trust, the trustee has legal title to the assets in the fund and holds those assets for the beneficial interest of the investors. Trust law protects the assets of the fund from creditor claims against the trustee. A mutual fund that is structured as a corporation is a distinct legal entity and holds title to the assets in the fund. Creditors of the fund manager have no claim against the assets of the mutual fund corporation.

### *Segregated Funds*

Segregated funds cannot be structured as trusts because the life insurance companies that offer them cannot act as trustees.<sup>14</sup> Instead, segregated funds are insurance contracts or policies. They are generally structured as “individual variable annuity contracts.” They are variable contracts because the value of the contract fluctuates on the basis of the market value of the reserves that the insurance company is required to hold in respect of the policies (generally, a diversified pool of assets that is notionally “held” by the insurer in a “segregated fund”). They are annuity contracts because they provide that the investor may either withdraw the accumulated value of the contract on its maturity date or receive a stream of income in the form of a single life annuity starting at that time. The early surrender of or partial withdrawals from the policy contract are allowed before maturity; this is

---

12 Generally, only a registered trust corporation may act as trustee in respect of services provided to the public under the Loan and Trust Corporations Act (Ontario), RSO 1990, c. L.25, as amended, section 213(2)(b). However, an exception in section 213(3)(b) allows a mutual fund management corporation to act as trustee of the mutual fund trusts it manages.

13 Funds that are redeemable on demand by the investor are referred to as “open-ended” funds. An open-ended fund may also be exchange-traded, in which case the investor usually looks to the trade with other investors for liquidity rather than relying on the redemption feature. Mutual funds that are exchange-traded but have no redemption right are “closed-ended” funds. The only funds considered in this paper are open-ended non-exchange-traded funds.

14 *Supra* note 12. The exception for mutual fund management corporations to act as trustees of the funds they manage does not extend to insurance corporations.

similar to the “redeemable on demand” right of mutual funds. For the purposes of presenting the investor’s interest under the contract, the fund is subdivided into notional units and the investor’s contract is represented as holding units.

The insurance company owns the assets of the segregated fund. The investor has no direct claim on those assets; his or her only claim is a contractual one, as a creditor, against the insurance company under the insurance policy. The assets of the segregated fund are largely protected from the claims of general creditors of the insurance company because the investors have a priority claim.<sup>15</sup>

Two principal features differentiate segregated funds from mutual funds. First, unlike mutual funds, segregated funds guarantee the return of a minimum amount to the investor at maturity or on death.<sup>16</sup> Like life insurance, the segregated fund provides the guarantee on death as a death benefit payable to the investor’s designated beneficiary. Second, the investor in the segregated fund may be entitled to creditor protection under provincial insurance laws that protect both the policy and any insurance proceeds from the claims of creditors of the insured investor and ensure that they do not form part of his estate.<sup>17</sup>

These two features may sway an investor’s decision to invest in a segregated fund or a mutual fund. The asset protection of the creditor-proofing feature may appeal to an investor who works in a professional practice or who is the owner-manager of a business. The capital guarantee, which applies only after a minimum specified investment period or on death, can protect against uncertain and declining stock markets, but that protection comes at a cost to the investor. Insurance fees for the guarantee can increase the cost per annum of holding the investment by 0.25 percent to 1.50 percent of the assets in the fund, depending on the fund’s risk profile and on whether the insurer provides a 75 percent or 100 percent guarantee.

### Regulatory Harmonization

The legal form of the different investment funds has not posed any significant impediment to the development of financial products that are virtually identical even when offered by very diverse financial service providers. Nevertheless, the service providers and their fund products are subject to different regulatory regimes.

15 See Friedlan, *supra* note 11, at 5-10, for a description of segregated funds.

16 This does not mean that mutual funds cannot provide a capital guarantee, but they generally do not. Nor does it mean that a segregated fund is not a segregated fund if it has no guarantee. Segregated funds offered to the investing public typically have at least a 75 percent guarantee to avoid regulation as a security. Guarantees in excess of 75 percent developed in response to higher demand for capital protection products. However, segregated funds offered as group plan policies typically have no guarantee. While that makes them securities, they are exempt from section 25 (trading registration requirements) and section 53 (prospectus requirements) of the Securities Act (Ontario), RSO 1990, c. S.5, as amended, under section 2.2 of Ontario Securities Commission Rule 45-501, “Exempt Distributions,” January 9, 2004.

17 Friedlan, *supra* note 11, at 16-17. Note that creditor protection is not absolute. It depends on who the beneficiary is and whether the designation is irrevocable, as well as on fraudulent-conveyance considerations in the case of an actual insolvency of the investor.

Mutual funds are regulated under provincial securities acts<sup>18</sup> administered by the securities commissions of each province, such as the Ontario Securities Commission (OSC).<sup>19</sup> There is no federal regulation of mutual funds. Segregated funds are subject to life insurance regulation under provincial and federal insurance statutes.<sup>20</sup> Segregated funds that provide a return guarantee of at least 75 percent are exempt from securities regulation.<sup>21</sup> Only financial advisers licensed under the respective regulatory regimes may sell the respective products; dual licensing is common today. Sales disclosure documents must be filed annually for both mutual funds and segregated funds with the respective regulatory authorities, and copies must be provided to the investors. The form and content of the annual simplified prospectus and information form for mutual funds and the information folder for segregated funds differ significantly, as does the timing of delivery to investors (after the sale of mutual funds and before the sale of segregated funds).

Today these products often cut across traditional regulatory boundaries, particularly when one product is structured to invest in the other. Regulators are increasingly challenged by the blurring of the traditional “four pillars” and “[t]he mismatch between the regulatory structure and the marketplace [that] has resulted in duplication and overlap of regulations, different regulatory treatment of similar products, and gaps in consumer protection.”<sup>22</sup> One government study has commented, “The public is entitled to comparable disclosure and protections for similar products.”<sup>23</sup>

In the interests of regulatory harmonization, the Canadian Securities Administrators and the Canadian Council of Insurance Regulators, as part of a joint forum of financial market regulators, have proposed a uniform national system of sales

---

18 See, for example, the Securities Act (Ontario), *supra* note 16.

19 The Canadian Securities Administrators is a national association of provincial commissions established to harmonize the regulatory structure across Canada and streamline the regulatory filing process for securities. Each commission maintains ultimate responsibility in its province.

20 Insurance Act (Ontario), RSO 1990, c. I.8, as amended (in Ontario) and the federal Insurance Companies Act, SC 1991, c. 47, as amended. The insurance regulators are (in Ontario) the Financial Services Commission of Ontario (FSCO) and, the federal Office of the Superintendent of Financial Institutions. Most insurance companies in Canada are federally incorporated, but they are still subject to provincial regulation if they operate in a province. Insurance regulators coordinate their activities through a national association, the Canadian Council of Insurance Regulators.

21 Securities Act (Ontario), *supra* note 16, paragraph (f) of the definition of “security” in section 1(1).

22 Ontario, Ministry of Finance, *Improving Ontario's Financial Services Regulation: Establishing a Single Financial Services Regulator* (Toronto: Ministry of Finance, September 2000), 3. In the interests of regulatory harmonization, the Ontario government has gone so far as to propose that the OSC and the FSCO be merged into a single financial services regulator. This merger does not appear to be progressing beyond the proposal stage, however. A subsequent document—Ontario, Ministry of Finance, *Establishing a Single Financial Services Regulator: Consultation Draft* (Toronto: Ministry of Finance, April 12, 2001)—is no longer available on the Ontario government's Web site.

23 *Improving Ontario's Financial Services Regulation*, *supra* note 22, at 2.

disclosure for both segregated funds and mutual funds. This new system would harmonize the format, content, method, and timing of delivery to the investor of the sales disclosure documents. The new uniform documents would replace all of the current documents prepared in respect of mutual funds and segregated funds.<sup>24</sup>

If regulatory authorities are concerned with harmonizing the regulation of similar products, tax authorities should be no less concerned with resolving the inconsistencies in the rules that govern the taxation of those same financial products. In fact, adopting the regulatory stance, one might say that the investing public is entitled to comparable tax rules for similar products.

## **ESTABLISHING A POLICY FRAMEWORK FOR TAX REFORM**

Are the different tax rules simply a function of the three different legal structures used for investment funds? What are the overall objectives and methods of taxing any legal structures in any tax system? By answering these questions, we can begin to develop a comprehensive policy framework and resolve the inconsistencies in the rules in a logical manner.

### **Legal Structures: Trust, Contract, and Corporation**

Do the legal structures of investment funds impose any restrictions on how those funds are taxed? It is important first to understand how each structure is defined in private law.

#### *Trust*

A trust is a relationship in which a trustee has an obligation to hold property for the benefit of other persons, called beneficiaries. The trust has no separate legal existence. A trust is created when a settlor transfers property to a trustee to hold and manage for the benefit of a beneficiary. The settlor may be a beneficiary of the trust he or she creates. Alternatively, a trust is created when the settlor, in a declaration of trust, declares himself or herself the trustee of certain property for the benefit of the beneficiary and specifies the obligation he or she assumes in that capacity. The creation of a trust involves both the transfer or conveyance of property and the undertaking of a duty or obligation by the trustee.<sup>25</sup> The trustee's obligation is enforceable by the beneficiary.

24 Joint Forum of Financial Regulators, *Rethinking Point of Sale Disclosure for Segregated Funds and Mutual Funds*, Consultation Paper 81-403, prepared by the Canadian Securities Administrators and the Canadian Council of Insurance Regulators (Toronto: Joint Forum of Financial Regulators, February 13, 2003).

25 D.W.M. Waters, *Law of Trusts in Canada*, 2d ed. (Toronto: Carswell, 1984), 3-10; Donovan W.M. Waters, "The Concept Called 'The Trust'" (1999) vol. 53, no. 3 *Bulletin for International Fiscal Documentation* 118-30, at 118-26; and David P. Stevens, *Trust Law Implications of Proposed Regulatory Reform of Mutual Fund Governance Structures*, a background research report to Concept

A mutual fund trust is created by a declaration of trust; the mutual fund management corporation declares itself trustee and settles a nominal amount on the trust. The trustee may name itself initial beneficiary. It then invites participation by the investing public, through a prospectus or other offering document, subject to the terms and conditions of the trust indenture and offering document. The public investors become beneficiaries of the trust through their purchase of trust units, but these subsequent contributions to the trust are technically not further settlements of the trust.<sup>26</sup>

### *Contract*

A contract is a legally enforceable agreement that creates reciprocal obligations between two parties. The parties exchange promises with each other—such promises having a value to each party—but a transfer of property need not be involved. In a contract between two persons for the benefit of a third person, the third person may not be able to enforce performance of the contract; in the case of a trust, however, the beneficiary is able to enforce the trustee's obligation to him or her. This is one key distinction between trust and contract; another is that a trust usually cannot be varied without the consent of the beneficiary unless the settlor has reserved the right to amend, but a contract in favour of a third party can generally be varied without that party's consent.<sup>27</sup>

A segregated fund is a contract between the insurance company and the investor. The investor exchanges value in the form of a premium for the promise by the insurer to pay either a lump-sum amount or a stream of future payments in the form of a single life annuity. No third party is involved in this contract.<sup>28</sup> The relationship between the investor and the insurance company is a creditor-debtor relationship: the investor is given a priority claim on the assets set aside by the insurance company in a segregated fund to satisfy the obligations under the contract.<sup>29</sup>

Trusts and contracts are generally thought to be distinct at law. Can a contract create a trust, or can a trust create a contract? In the case of a contract, if there is a duty on the holder to keep the assets separate and distinct, and if that duty is

---

Proposal 81-402 of the Canadian Securities Administrators (Toronto: Ontario Securities Commission, March 1, 2002), 41-43.

26 Stevens, *supra* note 25, at 43; and Donovan W.M. Waters, "An Overview of the Law of Trusts," in *Report of Proceedings of the Fortieth Tax Conference*, 1988 Conference Report (Toronto: Canadian Tax Foundation, 1989), 35:1-28, at 35:24.

27 Waters, *Law of Trusts in Canada*, *supra* note 25, at 46-54; and Stevens, *ibid.*, at 44-45.

28 There is of course a beneficiary of the insurance contract who is a third party but without privity to the contract.

29 The investor also has a claim under section 161 of the Winding-Up and Restructuring Act, SC 1996, c. 6, as amended, for any minimum amount that the insurer agrees to pay under the policy if the assets of the segregated fund are insufficient. See Friedlan, *supra* note 11, at 5-10.

spelled out in the transaction, a trust may be construed.<sup>30</sup> “[T]rust and contractual debt are not mutually exclusive.”<sup>31</sup> Although an insurance company is prevented at law from being a trustee, there is certainly an element of constructive trust in its contract with an investor by virtue of its holding the assets in a segregated fund. In the case of a trust, if a beneficiary gives value or consideration to the settlor in exchange for his promise to create a trust and transfer property to the trust, there is a contract to create a trust. If the property is not transferred, the beneficiary has a contractual claim against the settlor. Once the property is transferred, the beneficiary has a beneficial claim against the trustee.<sup>32</sup> A mutual fund declaration of trust establishes the terms and conditions under which a beneficiary may become a participant or unitholder in the trust, and it is therefore contractual in nature. Some observers take a stronger view that the trust is a contract.<sup>33</sup> Whichever view one prefers, segregated funds and mutual funds each exhibit aspects of both trust and contract.

### *Corporation*

Trusts and contracts are both relationships that have no separate existence apart from the parties to the relationship. A corporation, by contrast, has a separate existence, and it is considered an entity or person at law. A corporation has legal capacity in its own right and can own property. Articles of incorporation and the issuance of at least one share of capital stock result in the formation of a corporation. Others may participate in the corporation by purchasing shares in the corporation. The articles of incorporation and bylaws of the corporation can be viewed as contractual because they constitute the terms and conditions on which an investor becomes a shareholder. In the case of a mutual fund corporation, an investor becomes a shareholder by purchasing shares of the corporation, which can be redeemed at their net asset value in the future.

Segregated funds and mutual fund trusts are analogous to mutual fund corporations insofar as investors are able to purchase or sell (that is, redeem) portions or “units” of the fund or trust in a manner similar to the purchase or redemption of shares of a corporation.<sup>34</sup>

The dissimilarities of contracts, trusts, and corporations in the investment fund context are less evident than their similarities. “Trust law, contract law, and corporate law are highly flexible areas of law that place relatively few restrictions on . . . the design of fund constitutions.”<sup>35</sup> What does this mean with respect to their taxation?

---

30 Waters, *Law of Trusts in Canada*, supra note 25, at 67-69.

31 Ibid., at 69.

32 Ibid., at 47.

33 Stevens, supra note 25, at 45.

34 Waters, *Law of Trusts in Canada*, supra note 25, at 462.

35 Stevens, supra note 25, at 2.

## Tax Law

Tax law is distinct from private law. Taxing authorities often rely on private law for contextual or definitional focus;<sup>36</sup> however, they may ignore private law for taxation purposes. “[T]he taxing authority does not seek to deny the principles or rules of the private law, which govern . . . a concept. It simply does not follow them for the purposes of raising revenue.”<sup>37</sup>

The legal structures of mutual funds and segregated funds pose no great constraints on their respective rules for taxation. In common law countries, only two legal personae can be taxed—the individual and the corporation. One of the legal fictions created by the Canadian tax system is that a trust is an entity and has legal personality. This fiction permits the trust to be taxed as an individual, but it also allows the trust to avoid taxes on any income it pays to the beneficiaries; that income is then taxed in the beneficiaries’ hands.<sup>38</sup>

The tax rules for segregated funds, mutual fund trusts, and mutual fund corporations are set out in separate sections of the Act and are essentially exceptions to the norm of taxing individuals and corporations. Is there any unifying theme to these rules? In fact, there is: each set of rules is designed to flow income and capital gains out of the fund to the beneficiaries, so that the beneficiaries are taxed instead of the fund. Nevertheless, each set of rules adopts a different method or philosophy of flowthrough, and some rules achieve the flowthrough more successfully than others. The different methods create inconsistencies in the rules for the taxation of essentially the same financial product. The level of success in achieving the flowthrough is not dependent on how much or how little the tax rules conform or do not conform to the private law concepts of trust, contract, and corporation. On the one hand, the fiction of the trust as an entity can be a great hindrance in achieving an efficient flowthrough, as a later examination of the inconsistencies will show. On the other hand, as will also be seen, the ignoring of any entity, including the corporate one, can assist in enhancing a fund’s ability to put itself and its investors in the best tax position.

## Fiscal Transparency: The Passthrough, Conduit, and Imputation Approaches

“Fiscal transparency” is the taxation of the funds and their investors as if the investors held the securities directly rather than indirectly, such that they pay no more tax than they would if they held the securities directly. This is also referred to as “the flowthrough concept.” Pure transparency would ignore the entity entirely. More commonly, the entity is recognized as existing for tax purposes, even when it may not exist at law. Rules are then developed to move the income to the investors

---

36 Maurice C. Cullity, “General Concepts and Types of Trusts for Tax Purposes,” in the 1988 Conference Report, *supra* note 26, 36:1-27, at 36:1-2.

37 Waters, *Law of Trusts in Canada*, *supra* note 25, at 461.

38 *Ibid.*, at 462-66.

so that it is not taxed in the entity.<sup>39</sup> Canada generally has an objective of fiscal transparency or flowthrough for investment income earned indirectly through an arrangement or entity. There are many different ways to achieve transparency, and three methods are described herein—the passthrough approach, the conduit approach, and the imputation approach.

The passthrough<sup>40</sup> approach ignores the fund itself and allocates all income and losses directly to the investors, generally without any actual payment or distribution. The fund acts only as a reporting mechanism for tax purposes to accumulate amounts of income and capital gains and calculate the portions applicable to each investor. Often the calculations take into account the length of time an investor has been in the fund.<sup>41</sup> This approach is most often seen in the tax treatment of partnerships and their partners, but it can be applied to any entity or arrangement. The nature of the income is retained as it flows through to the investor, including any tax preferences for that income.

The conduit approach to flowthrough, sometimes referred to as the distribution-deduction approach, treats the fund as a taxable entity even when no actual entity exists at law. The fund is allowed to deduct from its income any amounts distributed to the investors, and it is taxable on any undistributed amounts. This method can also allow the fund to treat certain amounts as deemed distributions without an actual distribution to the investor, thus avoiding potential double taxation on that type of income.<sup>42</sup> Under this approach, income generally retains its nature and tax preferences as it flows through to the investor.

The imputation approach taxes the income in the fund, and the fund then distributes the net amount to investors as a distribution or dividend. The investor pays tax on the distribution and receives relief in the form of a tax credit for the entity-level tax that has already been paid by the fund. In this way, the entity-level tax is imputed to the investor as satisfying part of his or her tax liability. Income does not retain its character under this approach; all taxed income flowing out of the fund is treated as a dividend. Imputation systems are used primarily as a means of integrating corporate and shareholder tax positions when the entity is a corporation.<sup>43</sup>

---

39 Alexander Easson and Victor Thuronyi, "Fiscal Transparency," in Victor Thuronyi, ed., *Tax Law Design and Drafting*, vol. 2 (Washington, DC: International Monetary Fund, 1998), 925-68, at 925-27.

40 "Passthrough" is sometimes referred to as "flowthrough." In this paper, "flowthrough" refers to the generic term for fiscal transparency and "passthrough" is one approach that can be used to achieve flowthrough or transparency.

41 Eric M. Zolt, "Taxation of Investment Funds," in *Tax Law Design and Drafting*, vol. 2, supra note 39, 969-85, at 982-83.

42 *Ibid.*, at 984-85.

43 Graeme S. Cooper and Richard K. Gordon, "Taxation of Enterprises and Their Owners," *ibid.*, 811-94, at 854; and Howard J. Kellough and Peter E. McQuillan, "Integration Revised: Coordinating the Corporate and Personal Tax Systems," in *Business Tax Reform*, 1998 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1998), 22:1-25, at 22:1.

These approaches move from total transparency under the passthrough approach to partial transparency under the imputation approach. None of these approaches can be characterized as right or wrong; more important than the approach is the consistency of its application. However, “most industrial countries have not formulated rules for transparency in a thorough and consistent fashion.”<sup>44</sup> Canada uses all three approaches to achieve its objective of a flowthrough of investment income.

Each of the three tax vehicles available for structuring investment funds is identified in the Act as a “flow-through entity.”<sup>45</sup> But identifying segregated funds and mutual funds, both trusts and corporations, as “flow-through” does not imply a consistent philosophy or approach in the application of the rules. Segregated funds are “related segregated fund trusts.”<sup>46</sup> The segregated fund is taxed according to the passthrough approach. Mutual funds can be “mutual fund trusts”<sup>47</sup> and are taxed according to the conduit approach.

Mutual funds can also be “mutual fund corporations.”<sup>48</sup> The mutual fund corporation uses a hybrid approach consisting of conduit treatment for capital gains and Canadian dividend income and imputation treatment for all other sources of income. This hybrid approach is often referred to in the Canadian tax system as integration. The system is said to integrate the tax position of a shareholder with that of the corporation. Full integration means that the shareholder pays no more tax by carrying out an activity through a corporation than he or she would pay by carrying it on directly.<sup>49</sup> In other words, there is fiscal transparency.

Segregated funds and mutual fund trusts have a complete flowthrough of all types of investment income. The Canadian tax system provides for the full integration of investment income for Canadian-controlled private corporations (CCPCs) at a theoretical corporate tax rate of 20 percent.<sup>50</sup> However, it does not extend full integration to mutual fund corporations, so there will be “tax leakage” to the extent

---

44 Easson and Thuronyi, *supra* note 39, at 926.

45 Subsection 39.1(1). However, the “flow-through” concept as used in the Act is not general in nature but is solely for the purpose of dealing with the elimination of the capital gains exemption in 1994. In addition to mutual funds and segregated funds, the definition of “flow-through entity” includes an investment corporation, a mortgage investment corporation, a partnership, an employee profit-sharing plan, and three other types of trusts. This paper considers none of these other entities. They, in common with segregated funds and mutual funds, have an ability to earn capital gains both from an allocation from the funds and by disposing of units or shares of the funds. A comprehensive reform of all types of investment vehicles will ultimately have to consider the flowthrough method used by these entities and determine whether they could or should adopt the passthrough approach advocated herein.

46 Subsection 138.1(1).

47 Subsection 132(6).

48 Subsection 131(8).

49 Kellough and McQuillan, *supra* note 43, at 22:1-2.

50 *Ibid.*, at 22:8-12.

that the combined tax paid by the investor and the corporation will be greater than it would have been if the investor had earned that income directly.

Is it possible to reconcile the different approaches to flowthrough that the Act uses and make changes to the rules that will eliminate the inconsistencies? I believe that it is. How do we determine the best approach to take among the current alternatives? The effect of a particular approach on the investor is a helpful gauge.

### **The Investor's Perspective: Tax Efficiency**

The individual flowthrough rules determine the level of taxation of investors in segregated funds and mutual funds. The differences in the tax rules can have a significant impact on the amount of investment income (including capital gains) that is subject to taxation in any given year that investors have an interest in one of these funds. The flowthrough rules, therefore, determine the relative tax efficiency for investors in each type of fund.

Over the lifetime of an investment, an investor will be taxed on the same total amount of income, regardless of when the various amounts are allocated to him or her or realized on redemption. The amounts may vary in when they are taxed and whether they are taxed as ordinary income, as Canadian dividends, or as capital gains. Tax efficiency focuses on two main issues—timing and the tax rate that applies to the particular form of income. The tax rate is usually a function of the underlying investments in the fund rather than the specific flowthrough rules. The timing of the inclusion of items in an investor's income, though, can be affected by the flowthrough rules.<sup>51</sup> As will be seen, some of the rules can result in an unnecessary prepayment of taxes at the investor level.<sup>52</sup> A redemption at the net asset value of a fund reflects both gains realized by the fund and gains that have accrued. To the extent that the investor is taxed on the fund's realized gains on redemption and the fund distributes those same realized gains to beneficiaries, there is an element of—or at least a perception of—double taxation of the same economic gain: the redeemer

---

51 Often timing is also within the control of fund managers through their investment strategies, including holding-period decisions. A recent article suggests that funds with a buy-and-hold focus that minimize portfolio turnover are generally more tax-efficient and will have a greater after-tax rate of return than funds that are more actively managed, because they have fewer realized gains to distribute: see Amin Mawani, Moshe Milevsky, and Kamphol Panyagometh, "The Impact of Personal Income Taxes on Returns and Rankings of Canadian Equity Mutual Funds" (2003) vol. 51, no. 2 *Canadian Tax Journal* 863-901. Another recent article argues for the disclosure of after-tax returns for all mutual funds in Canada similar to the Securities and Exchange Commission requirement for funds in the United States. See Amin Mawani, "To Disclose or Not To Disclose After-Tax Returns of Mutual Funds" (2003) vol. 51, no. 5 *Canadian Tax Journal* 1908-17.

52 The buy-and-hold camp came up against the "prepayment doesn't matter" camp in another recent article. See Rudy Luukko, "Mutual Fund Experts Duke It Out on Tax Efficiency," *Toronto Star*, January 1, 2004. Both camps have their points, but neither looks at the role of the flowthrough tax rules in determining the overall tax efficiency of a fund.

pays taxes on the gain and so do the beneficiaries. However, it is more accurate to say that beneficiaries who receive the distribution are prepaying taxes in connection with the eventual redemption of their investment in the fund.<sup>53</sup> The accompanying table shows a simple example of a fund with two investors.

	Fund	Investor A	Investor B
	<i>dollars</i>		
Initial investment at cost .....	500	250	250
Fair market value when A redeems .....	1,000	500	500
Gain on sale/redemption .....	250	250	
Year-end distribution .....	<u>(250)</u>	—	<u>250</u>
Gain taxed .....	<u>0</u>	<u>250</u>	<u>250</u>
Position end of year			
Adjusted cost base .....	250	0	500
Fair market value .....	500	0	500

Only one economic gain is realized—the gain on the sale of the assets in the fund—but both investors are taxed on it. Later we will see how well the flowthrough methods in the Act manage to alleviate this double taxation effect.

Investment funds would be tax-efficient if the tax rules provided for the current taxation of income and the realized capital gains of the fund only once in the same year, in either the hands of a redeeming investor or the hands of a remaining investor, but not both. This would eliminate any prepayment effect, and there would be no double taxation of amounts in a particular year.

The rules are also viewed as tax-efficient if there is no tax leakage on the flow-through and income retains its character in the investors’ hands. Therefore, the best overall approach for investment fund taxation should be one that achieves not merely flowthrough to the investors, but tax-efficient flowthrough.

### **INCONSISTENCIES IN THE FLOWTHROUGH RULES**

This section of the paper examines the inconsistencies in the investment fund flowthrough rules in the context of the flowthrough methods available and currently used in the Act, and determines which methods are the most tax-efficient for the investor. Each of the three investment fund tax vehicles is compared and assessed on the basis of four criteria that represent the main areas of inconsistency

53 The amount taxed in the current year is added to the investor’s cost base to ensure that the amount is not taxed again on redemption; thus, no true double tax occurs. A prepayment of taxes does result from the current year’s mismatching of the fund and investor positions. While it is more accurate to call this a prepayment, throughout the paper I refer to this situation as the “double-tax, double-deduction” effect.

in their flowthrough rules.<sup>54</sup> These are (1) the matching of fund and investor positions with respect to capital gains, (2) the treatment of capital losses, (3) the flowthrough of income, and (4) the ability to use different allocation methods to flow income and capital gains to investors.

Two levels of taxation must be dealt with, because the fund arrangement or entity is interposed between the investor and the investments in the fund. The investor may realize gains and losses on redemption of his or her interest in the fund, and the fund may realize gains and losses on the sale of securities in the fund. The redemption price reflects both realized and unrealized gains and losses of the fund, so both the investor and the fund can realize the same economic gain or loss. The matching of these positions to avoid double taxation (deduction) of the same gain (loss) is of prime importance in the flowthrough rules. This section deals with capital gains; the following section deals with capital losses.

## Flowthrough of Capital Gains

### *Segregated Funds*

Segregated funds are deemed to be trusts for tax purposes,<sup>55</sup> with the insurer acting as trustee.<sup>56</sup> The property held in the fund is deemed to be the property of the trust and not that of the insurer.<sup>57</sup> However, the segregated fund trust is not subject to the normal flowthrough rules applicable to trusts.<sup>58</sup> The capital gains and losses of the segregated fund are deemed to be those of the policyholder beneficiary and not those of the trust.<sup>59</sup> This means that the segregated fund does not have to make

---

54 There are other areas of inconsistency in the taxation of segregated funds and mutual funds, but in this paper I focus on the flowthrough rules, which are the primary basis for taxing the funds. Other issues are ancillary. For example, mutual funds are subject to the foreign property rule and segregated funds are not (a 1996 proposal to make them subject to those rules has still not been implemented). Mutual fund trusts may return capital to investors but mutual fund corporations may not, and it is unclear whether segregated funds could do so. Mutual fund corporations may use section 51 of the Act, a reorganization rule, to defer taxes on the transfer of an investment from one class to another when classes in a multi-class corporate structure represent different investment objectives. Mutual fund trusts and segregated funds do not have access to a similar provision to allow investors to move on a tax-deferred basis. Mutual fund corporations are subject to capital taxes, and mutual fund trusts and segregated funds are not. Stop-loss and suspended loss rules are also inconsistently applied. Mutual funds have access to merger rules allowing a tax-deferred rollover; segregated funds do not.

55 Paragraph 138.1(1)(a).

56 Paragraph 138.1(1)(c).

57 Paragraph 138.1(1)(b).

58 The definition of “trust” in subsection 108(1) also excludes the segregated fund trust from trust rules specific to personal trusts, such as the 21-year deemed disposition rule and the preferred beneficiary election, among others.

59 Subsection 138.1(3).

these gains and losses payable to the investors in order for them to be taxed in the investors' hands. The income of the trust, including capital gains, is simply deemed payable to the beneficiaries. The amount of income or gain attributable to a particular beneficiary may be calculated by reference to the terms and conditions of the segregated fund policy.<sup>60</sup> This is the passthrough approach to flowthrough; it offers a great deal of flexibility as long as the terms and conditions provide for a reasonable allocation. The reasonable allocation may include an allocation to redeeming investors as well as investors who remain in the fund. No actual distribution or payment need be made to the investor. This passthrough approach allows segregated funds to perfectly match fund and investor positions.

If no redemptions occur in a year, and if the fund realizes gains on the sale of securities, all of the fund's gains will be allocated to the investors. The adjusted cost base (ACB) of the investors' holdings will be increased by the amount of the allocation<sup>61</sup> to ensure that the investor is not taxed again on this amount when he or she redeems. When there are redemptions, the fund gains will be allocated first to redeeming investors; the balance, if any, will be allocated to remaining investors. In both cases, the allocated gain is added to the ACB of the investors' holdings. In the case of a redeeming investor, this ACB addition has the effect of increasing the ACB so that it equals the proceeds on redemption, thus eliminating the redemption gain. The redeeming investor is left with only a gain that has been allocated from the fund.

A special election may be used by a segregated fund when some investors redeem units during the year and the fund has not realized gains on the sale of securities that equal or exceed the gains otherwise realized by the redeeming investors. The fund then has insufficient gains to allocate to the investor; in fact, the investor will realize some of the gains that the fund has not yet realized. The fund may elect to have some of its securities deemed disposed of at an elected amount somewhere between their ACB and their fair market value (FMV).<sup>62</sup> The resulting gain may then be allocated to redeeming investors to match the gain on their redemption. The fund is deemed to have reacquired the securities at the elected amount, thereby increasing the cost base so that the gain is not taxed again on an actual sale in the future. The accompanying table illustrates the allocation of capital gains from a segregated fund under three different scenarios.

---

60 Paragraph 138.1(1)(f).

61 Paragraph 53(1)(l).

62 Subsection 138.1(4).

	Scenario 1	Scenario 2	Scenario 3
	<i>dollars</i>		
Investor redemption			
Proceeds on redemption . . . . .	—	1,000	2,000
ACB . . . . .	—	<u>500</u>	<u>500</u>
Investor redemption gains . . . . .	—	<u>500</u>	<u>1,500</u>
Fund gains on sale of securities . . . . .	1,000	1,000	1,000
Fund deemed gains on subsection 138.1(4) election . . . . .	—	—	500
Fund gains allocated			
To redeeming investors . . . . .	—	500	1,500
To remaining investors . . . . .	1,000	500	0
Redeeming investor			
Capital gains from allocation . . . . .	<u>—</u>	<u>500</u>	<u>1,500</u>
Capital gains on redemption			
Proceeds on redemption . . . . .	—	1,000	2,000
Adjusted ACB (subparagraphs 53(1)(l)(iii) and (iv)) . . . . .	—	<u>1,000</u>	<u>2,000</u>
Capital gains on redemption . . . . .	<u>—</u>	<u>0</u>	<u>0</u>

The allocations and the ACB adjustments allow the segregated fund to perfectly match investor and fund positions. Outside basis (that is, the investors' ACB) is adjusted to ensure that an allocated gain is not taxed again in the investors' hands and to eliminate redemption gains so that the redeeming investor realizes only a gain allocated from the fund. Inside basis (that is, the ACB of the securities in the fund) is adjusted to trigger gains in the fund to match the investors' gains on redemption and, again, to eliminate the redemption gain so that only an allocated gain results.<sup>63</sup> The allocated gain is the gain from the fund, so no double taxation

63 The matching of outside basis (the amount an investor invests in a segregated fund) and inside basis (the amounts that the fund uses to invest in securities) is very important in the segregated fund model. To ensure a proper matching, only amounts that actually come into the fund from an investor are allowed in the investor's ACB of his or her units. Any sales charges incurred up front, which would be included in the ACB of mutual fund units, are not so included for segregated funds. Instead, these acquisition fees remain a memo off to the side and are treated as a separate capital loss of the investor, as are back-end fees, at the time of redemption of the applicable segregated fund units: see paragraph 138.1(1)(i) and subsection 138.1(6). Mutual funds may need to make some adjustments in this regard on the introduction of a full passthrough approach similar to the segregated fund approach. Note, however, that the majority of sales charges in the mutual fund industry are on a back-end basis.

can occur. The allocated capital gain is reported to the investor on a T3 supplementary slip (“T3”).<sup>64</sup>

### *Mutual Funds*

Mutual fund trusts<sup>65</sup> are subject to most of the trust rules in the Act.<sup>66</sup> The Act treats trusts as entities and taxes them as individuals.<sup>67</sup> The trust is allowed a deduction<sup>68</sup> in computing its income if it distributes income to the beneficiaries of the trust; that amount is then included in the beneficiaries’ income<sup>69</sup> and taxed in their hands. An amount is deemed distributed to the beneficiary if it is paid to the beneficiary or if the beneficiary is entitled to enforce payment of the amount.<sup>70</sup> This is known as the “paid or payable” concept. This concept identifies the flow-through method used by trusts, including mutual fund trusts, as the conduit approach, or the distribution-deduction approach. Any amounts not distributed by the fund are taxed in the trust at the highest marginal tax rate for individuals.

Mutual fund trusts may distribute their capital gains net of capital losses to investors, but not losses net of gains. The capital gain distribution is usually paid in cash or as reinvested units of the fund and reported on a T3. The reinvested units have a cost equal to the amount distributed.<sup>71</sup> The new units are added to the investors’ holdings, bumping the total ACB by their cost amount, to ensure that the distributed amount is not taxed again on redemption. This distribution does not avoid the potential for double taxation inherent in the two-tier structure of investor and fund. However, the mutual fund trust has access to a mechanism that attempts to alleviate this problem by allowing the fund to retain some of its capital gains rather than distribute them. This imprecise method of matching fund and investor gain positions is known as the capital gains refund mechanism (CGRM).<sup>72</sup> The CGRM

---

64 See also Borgmann, *supra* note 10, chapter 16, and Joel T. Cuperfain and Florence Marino, eds., *Canadian Taxation of Life Insurance* (Toronto: Carswell, 2002), chapter 18, for a more complete discussion of segregated fund taxation.

65 Defined in subsection 132(6) to be a unit trust resident in Canada whose only undertaking is the investment of funds and which complies with prescribed conditions with respect to the number of its unitholders and the public offering of its units. The mutual fund trust usually qualifies as a unit trust by meeting the redeemable-on-demand condition in paragraph 108(2)(a). This makes it an open-ended fund. If the mutual fund qualifies as a unit trust under paragraph 108(2)(b), it is a closed-ended exchange-traded fund.

66 The exceptions are outlined in the definition of “trust” in subsection 108(1) and include trust rules specific to personal trusts, such as the 21-year deemed disposition rule and the preferred beneficiary election, among others.

67 Subsection 104(2).

68 Subsection 104(6).

69 Subsection 104(13).

70 Subsection 104(24).

71 Subsection 248(25.3).

72 Subsections 132(1) and (4).

formula effectively calculates the fund's net capital gains for the year that are attributable to redeeming investors. Those capital gains do not have to be distributed to the remaining investors. The gains are included in the income of the fund, but the fund receives a refund of the taxes that would otherwise be payable on those gains. The CGRM often fails to reduce the distribution to be made to the remaining investors by a sufficient amount, with the result that both the redeeming and the remaining investors are taxed on some or all of the realized gains in the year. This imperfect matching of investor and fund gains results in a prepayment of taxes by some investors.

The CGRM is a point-in-time calculation: it is dependent upon the value of the securities in the fund at the end of the taxation year, and particularly on the amount of unrealized accrued gains embedded in that value.<sup>73</sup> Smaller accrued gains at year-end mean that the CGRM may not provide a full refund, even though investors themselves may have realized gains on redemption far in excess of the gains implied by the CGRM. The accrued gain can be affected by declines in the value of securities near the end of the year or by the fund's realizing gains on securities that are "winners" and continuing to hold securities with losses or nominal gains.

The mutual fund industry has attempted to address the inadequacies of the CGRM by developing a method of allocating gains to redeeming investors similar to that used by segregated funds. Favourable income tax rulings<sup>74</sup> issued by the Canada Revenue Agency (CRA) have allowed a mutual fund trust to treat part of the redemption proceeds paid to an investor as a payment of a capital gains distribution.

---

73 Under the basic CGRM, before the 2001 amendment to A and the addition of E (see *infra* note 76) the capital gains refund was equal to the lesser of (1) 14.5% of the capital gains redemptions and (2) the refundable capital gains tax on hand (RCGTOH). The capital gains redemption equalled  $A/B \times (C + D)$ , where A = amount paid on redemptions of units in the year; B = value of outstanding units at year-end plus A; C =  $100/14.5$  of RCGTOH ("realized gains"); and D = accrued gain of fund property at year-end (that is, unrealized gains). RCGTOH equalled the least of (1) 29% of taxable income for the year; (2) 29% of taxed capital gains (that is, realized gains less distributed gains) for the year; and (3) part I tax payable for the year.

In the formula above, D is the most problematic part; it creates the point-in-time deficiency and causes the CGRM to be inefficient in relieving the double-tax effect of the two-tier investment structure. The formula assumes that every person who redeems units during the year realizes a gain or loss based on the gain position of the fund at year-end—that is, the sum of the realized gains and the unrealized gains. As unrealized gains fluctuate, the assumed "average" of the formula also fluctuates. If investors, on average, redeem at higher gains than the formula average, the CGRM does not provide sufficient shelter. If redemptions occur at lower average gains, the CGRM will provide excess shelter.

When the fund has no unrealized gains at year-end, it must distribute all gains to avoid paying tax. This happens because the capital gains redemptions default to only a percentage of the RCGTOH; this becomes the limiting factor in the refund formula because it would be less than the refundable capital gains tax payable. The only way to optimize the fund position is to distribute all gains to reduce to nil the refundable capital gains tax payable.

74 CRA document no. 9817583, 1999. See also CRA document no. 2000-0041363, 2000, and CRA document no. 2001-009107A, 2002.

Amounts so treated are deductible by the fund in computing its income, and therefore are not required to be distributed to the remaining investors.<sup>75</sup> Such amounts are also excluded from the redeeming investors' proceeds of disposition, so that their redemption gain is reduced by that amount; they receive the amount as a distribution gain instead. Segregated funds, by contrast, add the capital gains allocation to the ACB as a means of reducing the redeemer's gain. The two fund models use different approaches, but the effect is the same—the gain on redemption is replaced by a gain allocated from the fund.

The income tax rulings were effectively given legislative sanction by amendments to the CGRM formula that precluded a potential doubling up of the CGRM benefits. The amended formula reduces the CGRM shelter for any gains allocated to redeeming investors.<sup>76</sup> The income tax rulings were an ad hoc response to an inefficient CGRM, but they do not solve the entire problem. The mutual fund still has access to a CGRM if the allocation to redeemers does not completely reduce the calculation to nil in the amended formula.<sup>77</sup> This may only serve to redress the inefficiencies of past years, when the CGRM provided little or no protection. However, investor and fund positions are not optimized in a mutual fund trust in the same manner that they are in a segregated fund.

If the gains realized by the fund exceed those realized on redemption by investors, the gains will be allocated to redeemers first. The fund may or may not have any CGRM shelter after that allocation. The balance of the fund's gains net of CGRM relief will be distributed to the remaining investors. Reinvested amounts will increase the investors' ACB of their units. In this respect, the mutual fund trust and the segregated fund are in much the same position. However, if investor gains exceed fund gains, the fund will only be able to allocate those gains to investors and will fall short of matching all of the investor gains. Unlike the segregated fund,<sup>78</sup> the mutual fund does not have an elective mechanism that allows it to create gains to

---

75 Unlike the CGRM, which requires a full distribution when the portfolio has accrued losses at year-end, the allocation to redeemers can result in a significant reduction in the distribution when capital gains are matched to redeemer gains. It is not necessary to consider the year-end accrued gain/loss position, only the actual gains realized by the investors.

76 See *supra* note 73. The capital gains redemptions formula on amendment became  $(A/B \times (C + D)) - E$ , where A is now reduced by the amount of gains allocated to redeemers so that it represents adjusted proceeds on redemption, and E is the amount of gains allocated to redeemers. See Nigel P.J. Johnston, "Tax Issues, Strategies and Pitfalls for Mutual Fund Investors," an unpublished paper prepared for a conference that was cancelled (McCarthy Tétrault LLP, Toronto, December 2002), 16. The mutual fund industry considers the amendments to the CGRM to be flawed, and IFIC has made submissions to the Department of Finance indicating that the adjustment itself is double-counted by virtue of being included in both A and E in the formula.

77 This happens when the redeemer gains are less than the CGRM shelter before the redeemer gain allocation is backed out.

78 See subsection 138.1(4).

match investor gains. The only way the mutual fund can create those gains is to go into the market and actually sell securities.<sup>79</sup>

Like mutual fund trusts, mutual fund corporations use the conduit approach for the flowthrough of capital gains. The mechanism is slightly different again: the mutual fund corporation must elect to have its dividends treated as capital gains dividends.<sup>80</sup> To the extent that the gains either are paid out as capital gains dividends to investors or are eligible for a capital gains refund, they are not taxable in the mutual fund corporation. The mutual fund corporation also uses a CGRM to reduce the amount of the dividends that must be paid to investors, to reflect the fact that investors will have realized gains on redemption, and to alleviate the double-tax effect thereof.<sup>81</sup>

To date, mutual fund corporations have not used the “allocation to redeeming investors” method, nor has the CGRM for corporations been amended, as the CGRM for trusts has, to compensate for the use of such an allocation. Notwithstanding this, there is no policy or technical reason that a corporation could not use the “allocation to redeeming investors” method, to treat part of the investors’ proceeds on redemption as a capital gains dividend.<sup>82</sup>

Mutual fund trusts have not yet made extensive use of the allocation to redeeming investors, even though it goes a fair distance in alleviating some of the CGRM inefficiencies. Some practical problems must still be solved.

### *The Problems*

The first problem is the mutual fund trust’s inability to truly match investor and fund positions. Mutual funds should be able to elect to create capital gains in the

---

79 In fact, some mutual funds have been known to do this at year-end to optimize the CGRM. The securities are sold and immediately repurchased to trigger a gain and increase the securities’ ACB.

80 Subsection 131(1).

81 See *supra* note 73. The CGRM is very similar to the method used by the mutual fund trust, except that the percentages are 14 percent instead of 14.5 percent and 28 percent instead of 29 percent. One difference in the mutual fund corporation’s CGRM is that the capital gains dividends paid in respect of the year are added to the capital gains redemptions in (1) of the formula set out in note 73. This can provide some relief even if the fund is in an unrealized loss position at year-end: see subsections 131(2) and (6).

82 From a corporate point of view, however, the allocation would not be an actual dividend payment but rather a taxable allocation that satisfies part or all of the mutual fund corporation’s election for capital gains dividends. This would not violate the corporate requirement for equal per-share dividends on shares of the same class. Note also that the mutual fund corporation may have a reduced opportunity to allocate capital gains to redeeming shareholders to the extent that it has non-taxable transfers between classes resulting from the use of the section 51 reorganization rule, which allows for tax deferral on such a transfer. Only actual taxable redemptions will qualify for the allocation. See Hugh Chasmar, “Mutual Fund ‘Switch Funds,’” *The Taxation of Corporate Reorganizations* feature (1998) vol. 46, no. 1 *Canadian Tax Journal* 172-94 for a discussion of the use of section 51.

fund when needed, just as segregated funds can. Without such an election, there is still the potential for double taxation of some of the funds' capital gains.<sup>83</sup>

The biggest hurdle to be overcome is the requirement of the CRA's rulings that any allocation of redeemer gains be reported on a T3 (or presumably a T5 slip ("T5") for mutual fund corporations, if they were to use the allocation to redeemers). Amounts that are paid or distributed out of a fund are reported as a trust allocation on a T3 or as a dividend on a T5. Amounts realized by an investor on redemption are reported on a T5008 slip ("Statement of Securities Transactions"). Segregated funds do only T3 reporting for their investors<sup>84</sup> because the funds are not securities<sup>85</sup> and because the segregated fund rules, as we have seen, actually eliminate the gain on redemption, so there is nothing to report on a T5008.<sup>86</sup>

The allocation to redeeming investors for mutual funds cuts across both reporting mechanisms because it moves an amount that is usually reported on the T5008 to the T3 or the T5. This is not a problem if the mutual fund manager does all the tax reporting for the investors in its funds. Mutual fund managers typically handle all T3 and T5 reporting; but investors' advisers or investment dealers often take on T5008 reporting to combine all of an investor's dispositions of securities, including mutual funds, in one consolidated statement. This practice has arisen as a matter of convenience, but also because the reporting guidelines for the T5008 are unclear.

The mutual fund industry would prefer to continue reporting redeemer gains via the reporting of proceeds of disposition on the T5008 even when the gains are distributed from the fund.<sup>87</sup> Transmitting information to the dealer to enable it to adjust the reported proceeds of disposition on the T5008 to exclude the redeemer allocation reported on the T3 would add a level of complexity at the manager level and at the dealer level.<sup>88</sup> This complexity is mandated by the CRA even though the investor is indifferent between reporting mechanisms. The amount of the gain incurred by the investor is the same whether it is reported indirectly as proceeds of disposition on the T5008 or directly as a gain on the T3 or T5. "The CRA's reluctance so far to accept T5008 reporting likely has to do with its perception that

---

83 This does not completely preclude the use of the allocation to redeemers, but it explains why it does not work as well as it should for mutual fund trusts.

84 From the investor's point of view, this is considered an advantage of segregated funds over mutual funds. All tax calculations and reporting are done for the segregated fund investor on one slip. Mutual fund investors must still calculate their own gains or losses on redemption with the proceeds of disposition that are reported on form T5008.

85 The definition of "security" in regulation 230(1) for the purposes of form T5008 reporting does not include segregated funds.

86 The absence of any gain on redemption of a segregated fund—that is, the redemption gain is always treated as a gain allocated from the fund—is likely the reason for excluding the segregated fund from the requirement for form T5008 reporting.

87 See Johnston, *supra* note 76, at 18; IFIC has made submissions to the CRA on this issue.

88 *Ibid.*, at 18. There is also the technical issue, when a mutual fund trust has adopted a December 15 tax year-end, of how to report any redemption gains occurring in the period from December 16 to December 31 and in which period they should be taxed.

T3 reporting is more readily audited.”<sup>89</sup> Unfortunately, this gives an appearance of policy formulation by administrative roadblock. At least one mutual fund manager has abandoned the use of the allocation to redeemers, leaving the way open for potential double taxation of more of its funds’ capital gains.

The mutual fund industry may well be arguing the wrong issue in this regard. Instead of focusing on what form is used for reporting, the industry may do better to focus on who does the reporting—the fund manager or the dealer. The problem is not really moving the redeemer allocation to the T3; mutual fund companies that also have segregated fund products are able to handle this without issue, and the T5008 is of course not necessary for the segregated fund. The problem is the passing of the information for mutual funds to another organization to have it remove that amount from its T5008 reporting.

Should the dealer even do that reporting in the first place? The Act appears to require a dealer to do the T5008 reporting when, acting as a nominee or agent, it receives the proceeds from a transaction and the transaction is “carried out in the name of the nominee or agent.”<sup>90</sup> The dealers that take responsibility for mutual fund T5008 reporting are nominees for their investors. The nominee is required to report the transaction because the issuer, in many nominee situations, is not aware of the ultimate identity of the security holder. In the mutual fund context, the mutual fund manager that is already doing the T3 or T5 reporting has knowledge of the ultimate investor. It is therefore not entirely true that the transactions are carried out only in the name of the nominee. In this situation, the mutual fund industry has reason to argue that it should be solely responsible for T5008 reporting, as it is for T3 and T5 reporting. If this approach is taken, the issue of passing information to the dealers disappears, and moving the redeemer gain to the T3 becomes less problematic and more easily managed by the fund company.<sup>91</sup>

The CRA’s own guidelines on this matter are confusing and contradictory.<sup>92</sup> They appear to give greater weight than the Act does to the trustee’s reporting on redemptions from the trust: “Publicly traded interests in a trust are securities. . . . The trust, as issuer of these interests, has to report the redemption, acquisition, or cancellation of the units or shares [sic] to the beneficial owner.”<sup>93</sup> The guidelines

---

89 Ibid., at 18. Audit ease is facilitated by the fact that form T3 reports the actual capital gains, while form T5008 reports only the proceeds of disposition and requires the CRA to rely on investors’ calculation of the realized gains.

90 Regulation 230(6).

91 This is a matter of investor education. Managers would have to make appropriate disclosures to investors to ensure that they understand that form T3 reports all of their gains, and that no additional calculations are required of them. This would be necessary so that investors would not double-count their gains. Mutual fund managers that also have segregated funds have already responded to this education issue: when those managers began reporting for segregated funds alongside mutual funds, they took great care to point out the reporting differences.

92 CRA form T4091, “T5008 Guide—Return of Securities Transactions,” 4-5 and 19-21.

93 Ibid., at 5.

also indicate that a transaction that is reported on a T3 does not need to be reported on a T5008.<sup>94</sup> Presumably, if the mutual fund manager can ensure that the whole amount of the redeemer gain is reported on a T3, as it is with a segregated fund, the need for any T5008 reporting, whether by fund or dealer nominee, is obviated. This brings us back to our first problem—the inability to match the redeemer gains completely to the fund position, because gains cannot be triggered by election as needed. This means that some amount of the proceeds is still required to be reported on a T5008.

### *Recommendations*

Segregated funds have a superior flowthrough of capital gains to investors that perfectly matches the fund and investor positions and avoids double taxation of the same economic gains. The passthrough approach available to segregated funds is the most equitable and tax-efficient for the investor. Mutual funds cannot achieve this level of tax efficiency yet. The tax authorities have sanctioned the allocation to redeeming investors as an acceptable policy, but this still falls short of achieving complete consistency with the segregated fund rules.

Mutual funds should be given access to the same rules that segregated funds use to match investor and fund positions, including the inside and outside ACB adjustments and the election to create fund gains to match investor gains. If access to the full matching mechanism were granted, the only tax reporting required for the mutual fund would be the T3 (or the T5 for the corporate mutual fund), and T5008 reporting would be eliminated. The CGRM would no longer be required<sup>95</sup> and could be repealed.<sup>96</sup>

In the interim, in the absence of full legislative reform for mutual funds, the mutual fund industry could gain access to the already sanctioned allocation to redeemers by resolving the reporting issues between themselves and the dealers. This would allow the industry to use the favourable rulings that some of its members have received for mutual fund trusts and achieve a greater level of efficiency than it currently enjoys.

### **Flowthrough of Capital Losses**

In the two-tiered structure of fund and investor, the investor may realize capital losses on redemption and the fund may realize losses on the sale of securities. Segregated funds can flow capital losses to investors; mutual fund trusts and corporations cannot.

---

94 Ibid. The guide indicates that a form T5008 is not needed for transactions that are reported under regulation 204, which is the regulation governing form T3 reporting.

95 See supra note 76. Whether or not the CGRM amendments are flawed is a moot point if the CGRM is no longer needed.

96 It is likely that the CGRM would remain in place for fund managers that do not adopt the redeemer methodology; if full implementation of a passthrough approach was ultimately required of all mutual funds, it would be phased out over a period of years.

### *Segregated Funds*

Capital gains and capital losses must always be accounted for and allocated separately by the segregated fund; they cannot be netted. The segregated fund may allocate capital losses to its investors in exactly the same manner as it does capital gains.<sup>97</sup> These allocated losses are reported on a T3.

With respect to losses, the ACB adjustments are negative<sup>98</sup> rather than positive. The ACB is reduced and the investors' losses on redemption eliminated and treated instead as losses from the fund. If fund losses exceed investor losses on redemption, the fund will allocate its losses first to redeeming investors to match their losses. The balance of losses will then be allocated to the remaining investors, and the ACB of their segregated fund units will be reduced. Investors may use their allocated losses to offset other capital gains in the current year, or they may carry them back three years or forward indefinitely against capital gains in past or future years.

If investor losses exceed fund losses, the fund may trigger losses to match investor losses; the fund will elect to have some securities deemed disposed of and reacquired at an elected amount between FMV and ACB.<sup>99</sup> If the fund has no securities with accrued losses for which the election may be made, another provision will automatically reduce the ACB of all securities in the fund, on a pro rata basis, by the amount of the loss required to match the investors' losses on redemption.<sup>100</sup> The remaining investors therefore do not benefit again from losses already incurred by the redeeming investors. The fund's losses are deducted only once—either by a redeeming investor or by a remaining investor. The passthrough approach offers tax efficiency for segregated fund capital losses in the same manner that it does for capital gains.

### *Mutual Funds*

Mutual fund trusts and corporations cannot allocate capital losses to investors. Capital losses realized in a year may be netted against capital gains realized that year to reduce any gains that must be distributed to investors. If a net capital loss results in a year, the fund may carry it forward indefinitely to apply against capital gains in future years. Practically speaking, it is impossible to carry the loss back three years once a fund has already distributed capital gains to investors.<sup>101</sup>

---

97 Subsection 138.1(3) and paragraph 138.1(1)(f).

98 Paragraph 53(2)(q).

99 Subsection 138.1(4). However, any loss triggered in excess of that required to match investors' losses on redemption will be treated as a superficial loss. This prevents the fund from arbitrarily triggering losses.

100 Subsection 138.1(5).

101 This would entail the reporting of new tax positions to thousands of investors after the fact and require them to amend previous years' returns. This is administratively unacceptable, so a loss carryback is never done by a fund.

Losses cannot be allocated to investors. Mutual funds anticipate a distribution or dividend, and a negative amount cannot be distributed or paid as a dividend. This actually results in a double counting of losses, because investor losses and fund losses are mismatched. The investor may realize and deduct a loss on redemption, and the fund may realize and deduct the same economic loss. If the losses could be allocated and matched in the same manner as they are in segregated funds, this double deduction would not occur and tax efficiency would be achieved.<sup>102</sup>

### *The Problem*

The Act's entity approach to trusts is a key factor in understanding why losses cannot be allocated to investors of mutual fund trusts. A trust is a relationship; no actual entity exists. The Act creates the fiction of a trust as an entity and treats the trust rather than its investors, who are the beneficiaries, as realizing all income, gains, and losses. The Act also requires a conduit to move those items out of the fund. That conduit is a payment. The passthrough approach, by contrast, entirely ignores the entity, whether it is real or notional.

The Canadian tax system has a general policy of not allowing losses to be utilized by anyone other than the person or entity that realizes those losses. Thus, only the trust is capable of using losses on sales of securities. This policy is applied inconsistently, however. In the first instance, the segregated fund is deemed to be a trust. This seems to indicate that the segregated fund is not able to allocate losses. But the Act has a series of other rules that override this first deeming provision, so that the segregated fund "trust" is ignored and the investors realize and use the losses.

The passthrough approach deals most effectively with the two-tier structure of the funds in eliminating the double-tax, double-deduction problem. It is consistent with the Act's general loss-utilization policy—the investors are the persons realizing and using the losses. The entity approach to mutual fund trusts imposes considerable inefficiencies on the taxation of the funds and their investors, especially with respect to losses. The "entity" should be ignored, as it is for the deemed segregated fund trust.

When the passthrough approach is taken, there is no need for a mechanism such as a payment to put amounts into the hands of investors. The segregated fund is treated as a reporting mechanism for investors, so payments are not necessary. The issue of a negative payment never arises with a segregated fund; the fund may allocate the negative amounts inherent in a loss.

The mutual fund corporation is a separate entity; it realizes the losses. Where flowthrough is an objective, it also has a double-tax, double-deduction problem inherent in the two-tier structure. Tax inefficiency is the result. The entity should also be ignored here, so that the losses can be viewed as realized by the investors and can be allocated to them for their use.

---

102 The double counting of capital losses is not an actual double-up, but one that occurs only in the current year. It is a temporary timing difference, just as it was with respect to the prepayment of tax on capital gains.

### *Recommendation*

The segregated fund allocation of capital losses again proves to be the most tax-efficient method. Mutual fund trusts and mutual fund corporations should be allowed to adopt the full passthrough approach to capital losses. They should be given access to the same rules that segregated funds use to match investor and fund positions, including the inside and outside ACB adjustments and the election to create fund losses to match investor losses.

### **Flowthrough of Income**

As we have seen, capital gains, and capital losses in the case of segregated funds, retain their character on the flowthrough from the fund to investors.<sup>103</sup> They are not subject to fund-level tax if they are allocated or paid to investors. This is generally true of other forms of investment income that flow through segregated funds and mutual fund trusts, but not mutual fund corporations.

### *Segregated Funds and Mutual Fund Trusts*

The trust rules in the Act provide for the designation of various types of investment income by both segregated fund trusts and mutual fund trusts. Amounts that are designated in the trust tax returns retain their character as payment or allocation on flowthrough to the investors in the funds. Specifically, dividends from taxable Canadian corporations retain their character on flowthrough and remain eligible for the dividend gross-up and tax credit regime.<sup>104</sup> Foreign-source investment income also retains its character, and flows through to investors with its associated foreign non-business-income tax credit.<sup>105</sup>

There is no provision in the Act to designate interest income from a trust. It is treated simply as “other income,” as if it were earned on the trust itself rather than on the underlying assets in the trust. Both types of income are taxed in the same manner, so nothing is lost to the investor in not being able to designate interest separately. Other types of investment income not designated separately are also treated as other income.<sup>106</sup>

103 Subsection 104(21) (mutual fund trusts), subsections 138.1(3) and 104(21) (segregated funds), and subsection 131(1) (mutual fund corporations) provide for the specific flowthrough as capital gains.

104 Subsection 104(19).

105 Subsections 104(22) to 104(22.4). See also John M. Fuke, “The Taxation of Trusts and Their Distributions,” in the 1988 Conference Report, *supra* note 26, 37:1-18, at 37:4-6.

106 Lloyd F. Raphaël, *Canadian Income Taxation of Trusts*, 3d ed. (North York, ON: CCH Canadian, 1993), at 331. Canada is the only common law country that restricts the flowthrough of income and gains from a trust to a few specific types of income and treats the trust itself rather than the underlying assets as a source of income.

### *Mutual Fund Corporations*

A mutual fund corporation is taxed on dividends as if it were a CCPC. The fund is subject to part IV tax on the dividends; that tax is refundable when the fund pays a dividend to investors.<sup>107</sup> In this way, dividends flow through the fund without incurring any tax at the fund level, and they retain their character as dividends eligible for the dividend tax credit.

Foreign investment income, interest, and other investment income do not flow through the corporation. They are first taxed in the corporation at the highest corporate tax rates. The net amount after tax may be paid out to investors as a dividend that is eligible for the dividend tax credit, or it may be retained in the fund. The investor obtains some tax relief but does not recover all of the taxes paid at the fund level. There is a net cost to the investor of earning any type of investment income, other than capital gains or dividends from taxable Canadian corporations, through a mutual fund corporation. The industry usually deals with this by restricting the securities held by the mutual fund corporation so that the fund earns little investment income. This practice reduces the tax cost, but it also limits the fund's flexibility.

### *The Problems*

The integration principle is applied inconsistently in the imputation approach to flowthrough for mutual fund corporations. In respect of Canadian dividends, the mutual fund corporation, as noted above, is taxed as if it were a CCPC. But a CCPC has access to the refundable part I tax, which reduces the overall corporate tax rate on investment income to approximately 20 percent—the rate at which full integration occurs<sup>108</sup>—and a mutual fund corporation is denied access to this refundable tax. In some respects, therefore, the mutual fund corporation is taxed as a public company. All other forms of investment income are taxed in the corporation at high corporate tax rates before distribution to investors as dividends.<sup>109</sup>

At least one observer has suggested that mutual fund corporations are taxed in this manner to ensure that public corporations do not obtain a tax advantage by investing through a mutual fund corporation.<sup>110</sup> In my view, a better approach is to

---

107 Subsection 131(5).

108 The CCPC must first add an additional tax on investment income of  $6\frac{2}{3}$  percent under section 123.3; then, on payment of dividends, it is entitled to a  $26\frac{2}{3}$  percent refundable amount under paragraph 129(3)(a).

109 Brian C. Weatherby, "Mutual Funds," in *Report of Proceedings of the Thirty-Seventh Tax Conference*, 1985 Conference Report (Toronto: Canadian Tax Foundation, 1986), 43:1-17, at 43:4-5.

110 See John D. McAlduff, "The Taxation of Investment in Financial Intermediaries—Mutual Funds, Mortgage Investment Corporations, Unit Trusts, Real Estate Investment Trusts, and Quebec Investment Corporations," in *Report of Proceedings of the Twenty-Seventh Tax Conference*, 1975 Conference Report (Toronto: Canadian Tax Foundation, 1976), 940-52, at 949.

allow the mutual fund corporation to flow other forms of income through to investors, just as segregated funds and mutual fund trusts do, thus retaining their character without any taxation at the corporate level. Public companies that are allocated such income would be taxed at the high corporate tax rate and would obtain no advantage. Other investors would have no tax leakage imposed by two levels of tax. Even at the theoretically full level of integration there is still some tax leakage, because provincial tax rates often take the corporation away from the theoretical 20 percent combined tax rate needed for full integration to occur.

### *Recommendation*

Both the passthrough approach and the conduit approach to flowthrough are equally efficient in permitting income to flow through to the investor while still retaining its character, and without triggering any fund-level tax. Both are superior to the imputation approach used by mutual fund corporations. At the very least, mutual fund corporations should be given access to the refundable part I mechanism to reduce the corporate tax leakage on the flowthrough of investment income. Ultimately, though, they should be given direct flowthrough by means of the passthrough approach, so that no tax is levied at the corporate level.<sup>111</sup>

### **Allocation Methods**

Capital gains and losses are allocated to redeeming investors on the basis of the actual gains or losses realized on redemption.<sup>112</sup> Income is not generally allocated to redeeming investors;<sup>113</sup> it is allocated or distributed only to remaining investors. Remaining investors may also receive an allocation or distribution of capital gains, and of capital losses in the case of segregated funds, if the fund has realized more capital gains and losses than the redeeming investors. What method should be used to make these allocations?

---

111 This would likely require provisions that would allow a mutual fund corporation to make designations of specific types of income similar to those for trusts in section 104.

112 It has been suggested that other methods could be used in the context of an allocation to redeemers by a mutual fund trust: see Johnston, *supra* note 78, at 16-17. A close examination of the segregated fund model, however, shows that the point is to match the actual gain or loss on redemption to the fund. Therefore, the actual gain or loss becomes the only practical method of allocation to redeeming investors. It avoids the problem, noted by Johnston, of potentially allocating more than the actual gain and creating a capital loss in the investors' hands.

113 It is theoretically possible to allocate income to redeeming investors in the segregated fund model, and some segregated funds may do so, but it adds a layer of complexity. The income would be allocated first, and the ACB of the investors' holdings would be adjusted upward. The realized redemption gain (or loss) would be adjusted downward (upward) before the capital gains and losses are allocated from the fund to match the adjusted investor positions on redemption. Not allocating income, except to remaining investors, eliminates the adjustment of the redeemer gains or losses, even though it allows redeeming investors to realize some of the fund's income in the form of a capital gain.

### *Segregated Funds*

As noted above, the passthrough approach for segregated funds deems income and capital gains of the fund to be payable to the investor and deems capital gains and losses to be those of the investors. These amounts are included in the income of the investors and taxed in their hands. There is no need to distribute an amount in either cash or units to evidence an allocation of income or capital gains. The income allocation is added to (and the capital loss allocation deducted from) the ACB of the investors' holdings.<sup>114</sup> The number of units and the value of the investors' holdings remain unchanged after the allocation.

The absence of a distribution requirement means that segregated funds have a great deal of flexibility in the methods they can use for allocating income and capital gains and losses to remaining investors. They are also able to avoid the system inefficiencies of tracking distribution units in their investor accounts. The only requirement is that the allocation be reasonable and in accordance with the terms and conditions of the policy. Segregated funds generally use a time-weighted method of allocation; this is often referred to as the "exposure-units" method. The fund calculates the time that an investor holds units in a fund by multiplying the number of units by the number of days or weeks that those units have been owned by the investor. The investor receives an allocation of the fund's income, gains, or losses as a proportion of his or her exposure units to the total of all investors' exposure units in the fund.<sup>115</sup>

This method ensures that investors who come into a fund in the latter part of a year are not taxed immediately at year-end on income, gains, or losses realized by a fund even before they became investors. They are allocated a portion of taxable income earned by the fund after their investment.<sup>116</sup> If the fund chooses to allocate income to redeeming investors, the exposure-units method provides for an allocation that represents income, gains, and losses realized by the fund only up to the time that the investor redeemed from the fund.<sup>117</sup>

Segregated funds are not restricted to the use of the exposure-units method, but that method often results in a more equitable and tax-efficient allocation from the investors' point of view. The exposure-units method does not change the total amount of income allocated to investors vis-à-vis the per-unit method; it changes only the amount that each investor receives. Some segregated funds use a year-end

---

114 Segregated funds may not make an income loss allocation to investors; they may allocate only capital losses. It is unclear whether the segregated fund can carry forward income losses to use against future income as a mutual fund can. This is one area in which the segregated fund is at a disadvantage vis-à-vis the mutual fund trust or corporation.

115 Cuperfain and Marino, *supra* note 64, at 382-83.

116 This assumes that all income and capital gains and losses of the fund are realized evenly over the year.

117 *Supra* note 113. Note the practical problem of allocating income to redeeming investors.

pro rata per-unit allocation<sup>118</sup> instead of the exposure-units method, but this is not as equitable or as tax-efficient.

### *Mutual Funds*

Mutual fund trusts are subject to the “paid or payable” rule<sup>119</sup> and must distribute income and capital gains to investors to get a deduction in computing the trust’s income. This requirement stems from the Act’s entity approach to trusts. Mutual funds usually make the distribution to investors of record on a specific date in the form of cash or reinvested units.<sup>120</sup> If an investor has fully redeemed from the fund, he or she will receive no distribution from the fund.

The amount of the distribution is calculated as a per-unit amount. Each investor receives the same amount of distribution on every unit he or she owns. When the distribution is made, the total assets of the fund decline by the amount of the distribution, so the per-unit net asset value also declines; the distribution is reinvested in new units at this lower net asset value per unit. In effect, the distribution comes back into the fund and increases the assets so the total value of the fund does not change, but more units are now issued and outstanding. Each investor holds units with the same total value before and after the distribution, but the original investment is now evidenced by two lots of units<sup>121</sup>—those from the original purchase and those from the distribution. The investor’s economic position has not changed, but an arbitrary accounting has caused the investor to own more units, each of a lower value than the units held before the distribution. The reinvestment of units increases the ACB of the investor’s holdings to reflect the distribution so that it is not taxed again on redemption.

It is more difficult to achieve an unequal time-weighted allocation when cash or units are involved.<sup>122</sup> Because a distribution reduces the assets of the fund, it must

---

118 The Manulife GIF, for instance, uses the per-unit allocation at the end of the year. This is because the GIF invests solely in mutual funds that distribute their income and capital gains on a per-unit basis at year-end. Other fund-on-fund structures may use a time-weighted method. See Cuperfain and Marino, *supra* note 64, at 387-88.

119 Subsection 104(24).

120 Cash distributions do not make up a great proportion of mutual fund distributions; most investors prefer to reinvest the distribution by taking units. Mutual funds are not required to make cash distributions available, and many newer funds allow only for a reinvestment of units on distribution. When cash distributions are allowed, they may make up only 2 to 3 percent of the total distribution.

121 This process continues year after year, dividing the original investment into multiple components that require extensive tracking. A fund will not be able to easily age all of its investor accounts. To calculate the financing fees that the manager pays on the basis of age and the market value of investor accounts, a complex aggregation of dividend units associated with the original investment will be required.

122 A time-weighted allocation in a mutual fund trust currently involves many stages: (1) a time-weighted allocation based on exposure units is calculated for each investor; (2) the largest time-weighted allocation for any investor is used to determine the amount per unit that all investors

affect all units in the fund equally so that the relative economic positions of investors in the fund are not changed. This forces the mutual fund to distribute on a per-unit basis,<sup>123</sup> or to do indirectly what the segregated fund can do directly,<sup>124</sup> to obtain the ACB adjustment to the investors' holdings so that double taxation does not arise on redemption. The key is to obtain the ACB bump;<sup>125</sup> a mutual fund must evidence the distribution by units to do so.<sup>126</sup> This means, however, that a mutual fund trust cannot be as equitable or as tax-efficient as a segregated fund if it can distribute only equal per-unit amounts rather than allocate time-weighted amounts. The same holds true for mutual fund corporations, which must pay dividends in the same amount per share to all investors that hold shares of the same class.

### *The Problem*

The mutual fund's inability to access a time-weighted allocation method stems from the "paid or payable" concept in the Act: the Act views the trust as an entity and uses the conduit approach to flowthrough. The Act's treatment also shows a misunderstanding of what an investor in a fund is actually entitled to receive from the fund.

An amount is paid or payable if "it was paid in the year to the beneficiary or the beneficiary was entitled in the year to enforce payment of the amount."<sup>127</sup> To understand the use of this concept, one must first understand the difference between personal and commercial trusts.<sup>128</sup>

---

will receive as a distribution; (3) the distribution is reinvested and the ACB of the investors' holdings bumped accordingly; (4) each investor reports as income his time-weighted amount, and the balance of his distribution is treated as a return of capital (which is not currently taxable) and reduces their ACB, leaving only the income amount in the ACB; and (5) all distribution units are consolidated back to the original number of units in the fund. Absurdly, this complex process does indirectly for a mutual fund what a segregated fund can do directly—leave the fund units unchanged and bump the ACB for each investor's time-weighted income allocation.

- 123 Sometimes a mutual fund can approximate a time-weighted method by distributing more often than annually. For example, bond funds often distribute their income each month on a per-unit basis. Using an allocation rather than a distribution will eliminate reinvested units from the system. However, a move to a time-weighted allocation in this case may not provide for any more precise allocation than the monthly per-unit allocation. The same fund might want to use an annual time-weighted allocation for its capital gains, however.
- 124 See *supra* note 122. The fund must go through the complex process described above.
- 125 See CRA document no. 2002-0154423, 2002. One fund manager has received a ruling that allows it to issue units at the fund level to evidence the reinvestment of a distribution and to immediately consolidate those units, so that the number of units outstanding is the same before and after the distribution. Investor accounts do not have to show the units, but they receive the ACB adjustment desired. This manager's funds are still required to use a per-unit distribution rather than time-weighting, but the ruling allows the manager to eliminate the tracking of distribution units from its record-keeping systems and to achieve some administrative efficiencies as a result.
- 126 Subsection 248(25.3).
- 127 Subsection 104(24).
- 128 The term "commercial trust" does not appear in the Act; the Act uses the term "unit trust."

A personal trust<sup>129</sup> is an inter vivos or testamentary trust set up by an individual, usually to provide for his or her family. The beneficiaries of the personal trust may be specifically named, or they may simply be identified as a class of persons (for example, children). The beneficiaries' rights to assets held by the trust may be vested<sup>130</sup> (that is, fixed) or contingent on some future event, or they may be subject to the discretion of the trustees. There is uncertainty surrounding who the beneficiaries are, and what the beneficiaries are entitled to from the trust. Which beneficiaries should be taxed on income and capital gains from the trust and which should not? The "paid or payable" concept answers this question. By paying an amount to a beneficiary or making an amount payable with a right to enforce payment, the trust identifies who should be taxed on income or on capital gains; any amounts not paid or payable to beneficiaries are taxed in the trust.<sup>131</sup>

Unlike a personal trust, a commercial trust does not result from the transfer of an individual interest. The commercial trust is excluded from many of the provisions in the Act relating to personal trusts.<sup>132</sup> It is more likely to have fixed vested beneficial interests, where all beneficiaries are known and their rights specifically set out in the trust document. A fixed interest results in certainty about who should be taxed. The income and gains of the trust are the income and gains of the beneficiaries, who have an interest in the underlying assets of the trust. The beneficiaries should pay the tax thereon,<sup>133</sup> and there should be no need for any amounts to be taxed in the trust.

A mutual fund trust is a commercial trust with fixed beneficial interests. Insofar as a segregated fund is deemed a trust by the Act, it too is a commercial trust with fixed beneficial interests. The investors have a right to receive a portion of the value of the fund's assets expressed as the net asset value per unit. The daily calculation of the net asset value per unit reflects the assets received as income less amounts paid as expenses; assets owned, including the unrealized capital gains and losses accrued thereon; and assets realized as capital gains and losses of the fund. The investors exercise their right to receive their share of the assets through their right to redemption on demand of their units.

"Paid or payable" is usually considered to mean "paid or payable on demand."<sup>134</sup> Despite this, the CRA does not consider the redemption-on-demand feature of a mutual fund trust to be sufficient to meet the requirement of a right to enforce

129 Defined in subsection 248(1); after 1999, it does not include a unit trust. See also Waters, *Law of Trusts in Canada*, supra note 25, at 30.

130 Waters, "The Concept Called 'The Trust,'" supra note 25, at 128. An interest is vested in interest when the beneficiary is known and any conditions precedent to the vesting have been met; an interest is vested in possession when the beneficiary is able to enjoy his or her beneficial interest now.

131 Waters, *Law of Trusts in Canada*, supra note 25, at 464-67.

132 Cullity, supra note 36, at 36:17-18. See also paragraphs (b) and (f) of the definition of "trust" in subsection 108(1).

133 Waters, *Law of Trusts in Canada*, supra note 25, at 465-66.

134 *Ibid.*, at 465.

payment.<sup>135</sup> The CRA suggests that an investor would have to redeem all units to obtain the income interest; the payment of the income element itself cannot be enforced on its own.<sup>136</sup> If the right to enforce payment is not evidenced by units, it will not have a cost amount.<sup>137</sup> Economically, though, a payment and reinvestment of units does not change the value of what the investor is entitled to receive from the fund. An investor does not receive value from the distribution—he was already entitled to that value by virtue of the net asset value redemption right. The distribution is an arbitrary way to give the investor a tax bill once a year. The “paid or payable” concept is an outdated means of doing so for a commercial trust.

The requirement of a distribution in the form of units in order to add an amount to the ACB of the investors’ holdings is directly at odds with the Act’s treatment of segregated funds. The segregated fund policy may give the investor the same right to redeem on demand as the terms of a mutual fund trust. The segregated fund may allocate income and capital gains and increase the ACB<sup>138</sup> of the holdings without a distribution of units. This implies that the segregated funds’ redemption on demand is sufficient to enforce payment. In fact, in my view, the Act deems it sufficient.<sup>139</sup>

The question of receiving a cost base adjustment on an allocation of income or gains from the fund is not a new one: more than 30 years ago one author identified the need to distribute to get an ACB adjustment,<sup>140</sup> and the matter still has not been satisfactorily resolved for the mutual fund industry. “The trust in the common law system is probably the most flexible device known to that system.”<sup>141</sup> Nevertheless, Canadian tax rules have made the trust extremely inflexible with their focus on the trust as an entity.<sup>142</sup>

---

135 *Interpretation Bulletin* IT-286R2, “Trusts—Amounts Payable,” April 8, 1988, paragraphs 8-10. See also John D. McAlduff, “The Taxation of Incorporated and Unincorporated Mutual Funds,” in *Report of Proceedings of the Twenty-Fourth Tax Conference*, 1972 Conference Report (Toronto: Canadian Tax Foundation, 1973), 185-96, at 187.

136 McAlduff, *supra* note 135, at 187.

137 Subsection 248(25.3). This section of the act was added by SC 2001, c. 17, for 1999 and following years. See Canada, Department of Finance, Notice of Ways and Means Motion To Amend the Income Tax Act, the Income Tax Application Rules and Certain Acts Related to the Income Tax Act, June 5, 2000, clause 112(5). The Department of Finance showed a great deal of vacillation on this issue. The original proposals for trust changes included a provision to add the cost to the ACB of the interest even when new units were not issued to evidence the income allocation. See Canada, Department of Finance, *Legislative Proposals and Explanatory Notes on Trusts* (Ottawa: Department of Finance, December 1998), clause 13(10). This provision was removed in the next set of draft proposals, and subsection 248(25.3), which requires the issuance of units, was added. See Canada, Department of Finance, *Revised Legislative Proposals and Explanatory Notes on Trusts* (Ottawa: Department of Finance, December 1999), clause 28(3).

138 Paragraph 53(1)(l).

139 Paragraph 138.1(1)(f).

140 McAlduff, *supra* note 135, at 187-88.

141 Waters, *supra* note 26, at 35:2.

142 Waters, “The Concept Called “The Trust,”” *supra* note 25, at 126. Waters indicates that it is more usual in common law jurisdictions to tax the trust on the basis of the passthrough

The preceding discussion has examined the problem from the point of view of a trust. Although a corporation is an actual entity, the mutual fund corporation has features similar to the mutual fund trust and should not necessarily have to pay dividends to put income and gains in the hands of investors for tax purposes. It is possible to ignore the entity in the tax world.

### *Recommendation*

Once again, the passthrough approach to flowthrough used by segregated funds is flexible, equitable, and tax-efficient in allowing the use of a time-weighted allocation method. The “paid or payable” concept should be dropped, and mutual fund trusts and mutual fund corporations should be given the ability to adjust the ACB of investors’ holdings for the amount of any income or capital gain or loss allocation they make to the investor, regardless of whether units or shares are issued to evidence the allocation. This approach would allow them to adopt time-weighted allocation methods if they so choose.<sup>143</sup>

## **TAX POLICY CONSIDERATIONS**

The adoption of the passthrough approach for the flowthrough of investment income will provide enhanced tax efficiency for investors in mutual funds, as it does for investors in segregated funds. It will also satisfy a number of tax policy objectives.<sup>144</sup>

### **Equity**

A good tax system ensures that taxpayers in similar situations are treated equally. At present, this is not the case with investors in segregated funds and mutual funds, and possibly with investors in other types of structures considered in the Act. The inconsistent rules create unequal tax positions for what is essentially the same investment product. Investors in mutual funds may prepay taxes in some instances or pay an extra layer of taxes in other instances. Segregated fund investors do not experience the same tax inefficiencies associated with the two-tier structure of fund and investor. From the investor’s perspective, the segregated fund passthrough approach provides the most efficient—and the most equitable—set of flowthrough rules.

---

approach, without any suggestion that an entity exists. Canada has adopted this approach for the segregated fund trust but not for the mutual fund trust.

- 143 In some cases, they may choose to use different methods. Income in a class may be allocated with one method (that is, per unit), and gains and losses with another (that is, time-weighted). If cash distributions were still desired, a fund would have to isolate all investors who wanted cash payments on a regular basis—from bond funds, for example—into a separate class (that is, class T or another new class) and use the per-unit method. Investors in other classes would receive time-weighted allocations at year-end with no new units. It is therefore possible to use more than one method in a fund, as long as only one method is used at a time for a particular class of investors and on a particular type of income.
- 144 Zolt, *supra* note 41, at 973-76; see also Robin W. Boadway and Harry M. Kitchen, *Canadian Tax Policy*, 3d ed., Canadian Tax Paper no. 103 (Toronto: Canadian Tax Foundation, 1999), 52-86.

## Neutrality

Tax rules should be as neutral as possible so that economic resources are allocated on the basis of market factors, not tax considerations. When products offered by two different industries are essentially the same, they should be judged on their investment merits, not on how they are taxed. If one product has tax advantages over the other, an unequal and non-neutral competitive environment is created.

## Protecting the Fisc

The tax authorities' objective is to raise revenue to finance the public fisc. To the extent that rule changes result in a reduction in revenues, the tax authorities are unlikely to be receptive to new rules governing the taxation of mutual funds unless some other tax policy objective can be realized at the same time. Tax policies often compete with one another. They may not all be achieved simultaneously, and trade-offs may be necessary. The recommendations set out in this paper can achieve several tax policy objectives at once, and they will not result in any net loss of revenue to the fisc.

Achieving tax efficiency at the investor level means avoiding double tax; it does not mean avoiding tax entirely. The efficient passthrough approach used by segregated funds provides that all items of income and gains and losses are taxed currently when they are realized. However, it also eliminates the double-tax, double-deduction effect inherent in the two-tier structure of pooled investment arrangements.

Tax authorities may see a reduction in revenue when the double-tax effect is eliminated. As noted earlier, however, this effect is only a timing difference; investors will realize and be taxed on the same total amount of income and gains or losses over the full investment period. With the passthrough approach, the elimination of the double-tax effect is accompanied by the elimination of the double-deduction effect. This should mitigate any lost revenues on a current basis.

## Economic Efficiency

Economic efficiency and growth are influenced by the accumulation of capital in the economy. Taxes that reduce the formation or supply of savings will reduce investment, which in turn will inhibit economic growth. To the extent that the adoption of the passthrough approach for mutual funds ensures that investors do not realize any unnecessary prepayment of taxes, savings are preserved, and no drain of capital occurs in the market.

## Administrative Complexity and Cost

A good tax system is administratively simple. It does not impose untoward cost on the taxpayer in complying with the rules, on financial intermediaries in reporting taxable amounts, or on the tax authorities in enforcing the rules. Unfortunately, the objective of simplicity is usually sacrificed in the interests of other tax policy objectives, particularly the objective of achieving equity for taxpayers.

The adoption of the passthrough approach for mutual funds appears, at first glance, to add complexity to mutual fund tax accounting and to cause fund managers to incur more costs. But management companies may have already made the necessary changes to support the segregated funds that they manage alongside mutual funds. Moreover, under the passthrough approach tracking of distribution units will no longer be required and T5008 reporting will be eliminated. Many players in the mutual fund industry are eager to improve the tax efficiency of mutual funds for investors, and they are not likely to find the changes a hardship. There are, after all, competitive benefits to the mutual fund industry in achieving tax treatment consistent with that of segregated funds.<sup>145</sup>

The investors will benefit from a more tax-efficient allocation on an annual basis and a simpler reporting mechanism. All amounts will be reported on one slip rather than two, and all calculations of capital gains and losses will be done for them. This will make it easier for them to comply with annual tax filing requirements. In addition, they will be able to see the consistency with segregated funds if they own both types of product, and they will find it easier to understand and deal with each.

Finally, the CRA will benefit from the adoption of the passthrough approach. One level of reporting will be eliminated, thereby reducing the administrative burden. The reporting of all income and gains from mutual funds on one readily auditable form enhances taxpayer compliance and makes enforcement easier for the tax authorities.

## CONCLUSION

There are no compelling reasons for the Act to tax segregated funds and mutual funds differently. The inconsistencies in specific rules result from the Act's inconsistent approach to the fiscal transparency of investment income when a pooled investment structure is used. These inconsistencies represent a serious flaw in the tax system. The Act appears to focus on legal form over economic substance, though even this treatment is not applied consistently. Legal form is neither determinative nor restrictive in the setting of tax rules for these investment funds, and it is not necessary for tax law to conform to private law principles.

---

145 The allocation-to-redeemer method would be the least complex means of achieving improved tax efficiency for mutual funds from an administrative and systems point of view, and it would result in the greatest benefit to investors. It requires an accurate ACB and gain and loss accounting for all investors, which are likely already in place for most managers. It also requires an ability to report gains and losses at the investor level each year and enhanced systems for tax reporting. The introduction of a time-weighted allocation method would be considerably more complex and costly for fund managers to implement, with a smaller overall increase in tax efficiency for investors. Investors who purchased late in a year would benefit the most. Some managers might not wish to use a time-weighted method because of its cost of implementation. In that case, it might be harder for the managers to counter the widely held view that mutual funds are less tax-efficient than other investments, including individual direct investments, because they result not only in the purchase of investment units but also in a potential tax bill when investments are made late in the year.

In determining the tax rules for segregated funds and mutual funds, the taxing authorities need to apply a more comprehensive and consistent framework than they currently use—a framework such as the one outlined in this paper, which would allow them to focus on an overall objective of attaining fiscal transparency by the most efficient method. Such an approach would disregard legal form and look instead at the economic substance of an investor's earning investment income through any type of pooled arrangement. This analysis would likely result in the use of the passthrough approach for all such investment structures because it gives the most accurate expression of economic substance.

The adoption of the passthrough approach for mutual funds, and ultimately for other investment funds, would correct the inconsistencies and greatly improve the tax system. It would allow mutual funds to provide for the perfect matching of capital gains and losses between a fund and its investors. This would eliminate the double-tax, double-deduction problem inherent in the two-tier investment pooling arrangement. The reporting of gains and losses would be streamlined into one reporting mechanism rather than two.

The passthrough approach would also eliminate the extra level of taxes imposed on investment income earned through a mutual fund corporation. In addition, funds would have more flexibility in allocating income, gains, and losses to investors by using methods that reflect the amount of time that an investor has been in a fund.

In sum, tax policy objectives of equity, neutrality, and efficiency would be enhanced by adoption of the passthrough approach with no net loss of revenue to the government. No substantive administrative burden would be added to the mutual fund industry, and investors and tax authorities alike would realize administrative efficiencies.

Years of ad hoc attempts on the part of the mutual fund industry to change the inconsistent rules in the Act have had limited results. Issues have been dealt with in isolation, without either the industry or the legislature fully understanding what the overall perspective or objective should be. It becomes easier to justify changes in rules on a tax policy basis when a comprehensive approach or framework is used. It is hoped that this paper provides just such a framework.