Mutual Fund Trusts and Unit Trusts: Selected Tax and Legal Issues

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PRÉCIS

Il existe divers moyens de mettre en commun les fonds investis par des épargnants à titre de placement. Le moyen le plus utilisé semble être celui de la fiducie, soit habituellement une «fiducie d'investissement à participation unitaire» ou une «fiducie de fonds mutuels», tels que ces termes sont définis dans la Loi de l'impôt sur le revenu. Grâce à leurs particularités fiscales, les fiducies d'investissement à participation unitaire et les fiducies de fonds mutuels constituent un moyen de placement qui convient au plus grand nombre possible d'épargnants, y compris les personnes qui investissent dans des régimes de revenu différé, tels les régimes enregistrés d'épargne-retraite, les régimes de participation différés aux bénéfices et les fonds enregistrés de revenu de retraite.

Cet article comporte une discussion de points particuliers souvent rencontrés par les conseillers fiscaux relativement à la formation de ces fiducies. L'auteur examine la structure de base de l'impôt sur le revenu et de la réglementation en matière de valeurs mobilières s'appliquant aux fiducies puis, il analyse en détail les exigences essentielles en vertu de la Loi pour former une fiducie comme fiducie d'investissement à participation unitaire ou fiducie de fonds mutuels. À cet égard, l'auteur passe aussi en revue les changements récents apportés par Revenu Canada à sa politique relative à la question de savoir si les parts d'une fiducie donnée sont considérées rachetables «sur demande» aux fins de former une fiducie d'investissement à participation unitaire à titre de fiducie d'investissement à participation unitaire «à capital variable», et d'autres positions de principe. L'auteur conclut que la politique de Revenu Canada est généralement propice à l'atteinte des objectifs commerciaux de la fiducie. Il aborde aussi les questions fiscales que doivent souvent se poser les conseillers pour s'assurer que les parts d'une fiducie seront admissibles à titre de placement dans des régimes de revenu différé, et analyse certaines des anomalies relatives au rachat et à la distribution dont les porteurs de parts font l'objet. Enfin, l'auteur se penche brièvement sur l'utilisation de différentes structures de frais de gestion qui varient selon le montant investi par les porteurs de parts.

ABSTRACT

Various vehicles exist through which funds contributed by a number of investors can be pooled for investment purposes. The most commonly used

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vehicle appears to be the trust, usually structured as a “unit trust” or a “mutual fund trust” as defined in the Income Tax Act. The special tax attributes of unit trusts and mutual fund trusts make them suitable investment vehicles for the widest possible group of investors, including persons investing within deferred income plans such as registered retirement savings plans, deferred profit-sharing plans, and registered retirement income funds.

This article reviews selected issues faced frequently by tax advisers in the creation of these trusts. The article first reviews the basic income tax and securities regulatory framework within which such trusts operate, and then examines in some detail the essential requirements under the Act to constitute a trust as a unit trust or a mutual fund trust. In this context, the author also reviews recent policy changes adopted by Revenue Canada in relation to the question whether units of a particular trust are considered redeemable “on demand” for the purpose of constituting a unit trust as an “open-ended” unit trust, and other policy positions. The author concludes that Revenue Canada’s policy is generally conducive to the attainment of the commercial goals of the trust. The article also reviews tax issues faced by advisers in ensuring that units of a trust will qualify for investment within deferred income plans, and examines some of the distribution and redemption anomalies to which unit holders are subject. Finally, the article briefly reviews the use of different structures in which the fee charged by the manager varies with the amount invested by particular unit holders.

INTRODUCTION

Any pooled investment may be structured using a corporation, a partnership, or a trust (other approaches, such as “syndicate” or joint venture, may be inappropriate where large numbers of investors are involved). Limited partnership units listed on a stock exchange will qualify for investment within a registered retirement savings plan (RRSP) or other deferred income plan pursuant to draft regulations that are intended to have effect after 1992,[1] and this may make limited partnerships more attractive as pooled investment vehicles in the future. Until now, corporations and trusts have been the most commonly used pooling vehicles for “passive” investments by the widest possible group of investors. Pooling an investment using an ordinary public corporation or an ordinary trust will usually entail a degree of inefficiency because investment income and gains earned by a public corporation and distributed to its shareholders are essentially taxed at punitive combined rates, and ordinary trusts are subject to a number of rules that are undesirable in a commercial context (such as the rule that deems a trust to dispose of its property every 21 years).[2] The inefficiencies

[1] See the draft amendments to regulation 4900(1)(m) of the Income Tax Regulations, CRC, c. 945, as amended, in Canada, Department of Finance, *Release*, no. 93-005, February 4, 1993.

[2] Subsection 104(4) of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.

of pooling an investment using a corporation are significantly alleviated (but not in all cases eliminated) if the corporation qualifies for special refunds available to an "investment corporation" or a "mutual fund corporation."[3] The use of a trust is attractive because from the outset the trust is clearly a conduit vehicle for investment income and capital gains,[4] and, where the trust qualifies as a unit trust or a mutual fund trust, the undesirable rules applicable to ordinary trusts can be avoided.

More in-depth comparison of the alternate investment vehicles can be found elsewhere.[5] Most pooled passive investments are structured using trusts, and the rest of this article deals exclusively with investment vehicles structured as unit trusts or mutual fund trusts.

This article does not attempt to be a comprehensive review of all the income tax issues that affect unit trusts and mutual fund trusts and, in particular, does not significantly address the myriad of special considerations applicable to a trust with non-resident unit holders. Rather, the article focuses on the most frequently encountered issues faced by tax advisers in the structuring of trusts intended primarily for Canadian investors.

General Considerations

Basic Tax Considerations Relating to Unit Trusts and Mutual Fund Trusts

Unit trusts and mutual fund trusts are the trusts most commonly used in a business context. The basic taxation of these trusts and of the trust unit holders has been reviewed elsewhere.[6] In addition to the conduit feature, which is an advantage to all trusts, the primary advantage of using a unit trust or a mutual fund trust is that each avoids the 21-year deemed realization rule and the other undesirable rules applicable to ordinary trusts.[7] Furthermore, mutual fund trusts receive particularly advantageous treatment, including the following:

1) Mutual fund trust units automatically qualify for investment within RRSPs, deferred profit-sharing plans (DPSPs), and registered retirement income funds (RRIFs) (herein referred to as "deferred income plans") under regulation 4900(1)(d).

2) Mutual fund trust status is useful when the underlying investments are foreign property (as described below).

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[3] As defined in subsections 130(3) and 131(8), respectively.

[4] As a result of the deduction available under subsection 104(6) and the designations available under subsections 104(19) through (21), (21.2), and (22), and elsewhere in the Act.

[5] Risa E. Levine, "Income Tax Considerations of Mutual Funds," Insight Seminar, May 1988, 1-17 and appendixes; and Douglas A. Cannon, "Taxation of Pooled Funds," in *Current Market and Legal Developments in the Mutual Fund Industry* (Mississauga, Ont.: Insight Press, November 1986), tab 3.

[6] See supra footnote 5. See also "Conduit Corporations and Trusts," in *Ward's Tax Law and Planning*, vol. 5 (Scarborough, Ont.: Carswell) (looseleaf), chapter 18.

[7] Paragraph 108(1)(j).

3) A unit of a mutual fund trust constitutes a "Canadian security" for the purpose of the capital property election in subsection 39(4).[8]

4) A mutual fund trust is not subject to the "designated income" rules under part XII.2 of the Act otherwise applicable where a trust has non-resident or certain tax-exempt beneficiaries (note, however, that a trust established or maintained primarily for the benefit of non-residents may be deemed not to qualify as a mutual fund trust).[9] Furthermore, a unit of a mutual fund trust can, in specified circumstances,[10] escape characterization as "taxable Canadian property."

5) A mutual fund trust can, within limits that depend in part on the extent of unit redemptions in a year, claim a refund of any tax paid by it on capital gains (that is, assuming that the trust chooses not to avoid the tax liability by distributing the capital gains to its unit holders and claiming the appropriate deduction under subsection 104(6) for income payable to beneficiaries).[11] The trust indenture for a mutual fund trust should therefore permit such refunds to be taken into account in determining distributions to unit holders, to enable the trust to maximize its asset base.

A more comprehensive list of the advantages of mutual fund trust status is contained in a number of articles.[12]

In many cases, then, and even if only for the sake of flexibility, one would prefer to establish a pooled investment trust as a mutual fund trust and not merely as a unit trust. It should be noted that to qualify as a mutual fund trust, the trust must also constitute a unit trust.[13]

Finally, there are some potential disadvantages to using any trust in a commercial setting, including the inability to flow out losses. A trust is permitted to deduct less than the full amount of income payable to beneficiaries, and, where appropriate designations are made, the trust can in this manner use losses of prior years without subjecting the beneficiaries to income tax on the designated distributions (such designations will, however, reduce the adjusted cost base of the trust units to the beneficiaries).[14] However, these rules do not apply in all circumstances,[15] and accordingly it may be advisable to draft the trust indenture in a manner that permits the trust to use prior years' losses by retaining in trust sufficient amounts that would otherwise be payable to beneficiaries.

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[8] Subsection 39(6).

[9] Subsection 132(7).

[10] Subparagraph 115(1)(b)(viii).

[11] Subsection 132(1).

[12] See, for example, Maurice C. Cullity, "General Concepts and Types of Trusts for Tax Purposes," in *Report of Proceedings of the Fortieth Tax Conference*, 1988 Conference Report (Toronto: Canadian Tax Foundation, 1989), 36:1-27, at 36:17-18.

[13] Paragraph 132(6)(a).

[14] See paragraph 104(6)(b), subsections 104(13.1) and 104(13.2), and subparagraph 53(2)(h)(i.1).

[15] See, for example, subparagraphs 108(1)(j)(ii) through (vi).

Basic Regulatory and Legal Framework

In general, securities legislation provides that trust units can be sold only under a prospectus (entailing comprehensive disclosure requirements) unless a specific prospectus exemption is available.[16] A point of importance to the tax adviser is that trust units distributed under a prospectus are also subject to policy statements proclaimed by the Canadian securities administrators, which, as outlined below, impose several tax-relevant requirements.

Prospectus exemptions are available, in general terms, where prospectus-level disclosure is thought not to be required to protect the investor, particularly in circumstances where the investor is assumed to have a sufficient degree of sophistication in investment matters and is therefore assumed to be able to evaluate the investment without the aid of a prospectus. One useful prospectus exemption is for a distribution to an investor who acquires units as principal and pays at least $150,000 (in Ontario)[17] or $97,000 (in British Columbia and certain other jurisdictions).[18] The Ontario Securities Act deems qualifying trust corporations that purchase for fully managed accounts to be acting as principals for this purpose,[19] and certain other provinces, including British Columbia, extend this treatment to portfolio managers.[20]

In practice, trust units are generally sold under a prospectus or are sold to pension funds or wealthy individuals under the $150,000/$97,000 exemption. Where a prospectus is used, the practice is to file an annual simplified prospectus and an annual information form (each of which will require input from the tax adviser) and related material. Where a prospectus exemption is relied on, trust units are distributed by way of an offering memorandum, which is updated when material changes occur (offering memoranda are required in certain circumstances—for example, where advertising activities are undertaken).[21]

As indicated above, in addition to the legislative requirements, the structure of a trust vehicle that offers units for sale pursuant to a prospectus is also affected by policy statements adhered to by the provinces and territories—in particular, *National Policy Statement* no. 39. Aspects of this and other policy statements pertinent to tax advisers include:

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[16] Ontario Securities Act, RSO 1990, c. S.5, as amended, section 53; and British Columbia Securities Act, SBC 1985, c. 83, as amended, section 42. Other Canadian jurisdictions have similar legislation.

[17] Ontario Securities Act, supra footnote 16, section 72(1)(d); and Ontario Securities Act Regulations, O. reg. 1015, as amended, section 27.

[18] BC Securities Act, supra footnote 16, section 55(4); British Columbia Securities Regulation, BC reg. 270/86, as amended, section 118.

[19] Ontario Securities Act, supra footnote 16, section 72(2).

[20] See, for example, BC Securities Act, supra footnote 16, section 55(1)(b).

[21] O. reg. 1015, supra footnote 17, section 32(2); and BC reg. 270/86, supra footnote 18, section 127.

1) The prospectus must describe the income tax consequences of distributions to unit holders (including reinvested amounts), the redemption or sale of units, and any transfers between funds.[22]

2) Where trust units are qualified investments for RRSPs and other deferred income plans, or where the trust is to be a registered investment (see below), the prospectus must disclose the effect of that qualification and must disclose whether an investment in trust units by such a deferred income plan is subject to the foreign property limit or other limitations under the Act.[23]

3) Where trust units are not qualified investments for deferred income plans, this fact must be disclosed in the prospectus.[24]

4) The net asset value of the trust units must be calculated at least on a weekly basis for the purpose of the issue or redemption of trust units, except that, with the approval of the unit holders, trust units may be valued less frequently (but at least on a monthly basis).[25] As further discussed below, the frequency of valuations will be relevant in the determination whether the trust qualifies as an open-ended unit trust under paragraph 108(2)(a) of the Act (by virtue of its units being redeemable "on demand") or whether it must meet the investment restrictions contained in paragraph 108(2)(b).

5) If the fund was in existence on January 1, 1988 and at that time the units were being valued only on a monthly basis, monthly valuations can continue.[26]

6) Where the trust invests in permitted derivatives, daily valuation is required.[27]

7) Section 13.04 of *National Policy Statement* no. 39 provides as follows:

> *Suspension of redemptions*.—A mutual fund may suspend the right to tender its securities for redemption or may postpone the date of payment upon redemption:
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> (1) for any period when normal trading is suspended on any stock exchange, options exchange or futures exchange within or outside Canada on which securities are listed and traded, or on which permitted derivatives are traded, which represented more than 50% by value or underlying market exposure of the total assets of the mutual fund without allowance for liabilities;
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> (2) where the head office or registered office of the mutual fund is in Canada, with the consent of the securities authority in the Province or Territory of Canada in which such office is situate; or

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22 Ontario Securities Commission, *National Policy Statement* no. 36, "Mutual Funds—Simplified Prospectus Disclosure System," June 15, 1990, OSCB 2404, schedule A, item 13.

23 Ontario Securities Commission, *National Policy Statement* no. 39, "Mutual Funds," December 16, 1988, OSCB 5041, amended December 4, 1992, OSCB 5646, section 2.02.

24 Ibid.

25 Ibid., at section 11.05(1).

26 Ibid., at section 11.05(2).

27 Ibid., at section 11.05(3).

(3) where the head office or registered office of the mutual fund is in the United States of America, with the consent of the Securities and Exchange Commission.

A provision in the relevant trust indenture that permits the suspension of redemptions by the trustee or manager in specified circumstances is almost universal, and will again raise the issue, further discussed below, whether the trust units are to be considered redeemable "on demand" for the purpose of qualifying as an open-ended unit trust under paragraph 108(2)(a) of the Act.

In addition to the specific regulatory requirements, the administration of a unit trust or a mutual fund trust is subject to the application of the common law as it affects all trusts—the most important application being a duty on the trustee to act in a fiduciary capacity and to act impartially as between beneficiaries.[28] In the context of "business trusts" such as unit trusts and mutual fund trusts, the trust indenture will usually set out the rights of the beneficiaries in detail, particularly with respect to the nature, quantum, and timing of payments to be made by the trustee to the beneficiaries. In this manner, the trust indenture will, of course, restrict or attempt to exclude entirely the discretionary powers (and concomitant duties) often accorded to trustees in non-business contexts.

QUALIFICATION AS A UNIT TRUST OR A MUTUAL FUND TRUST

Unit Trust

Unit trusts are defined in subsection 108(2) of the Act. The essential issue in respect of unit trusts will usually be whether a particular trust qualifies under paragraph 108(2)(a) as an open-ended unit trust or, if it is unable to meet that definition, whether it meets the investment restrictions imposed under paragraph 108(2)(b). In the majority of cases, if only for the sake of flexibility, it will be desirable to qualify under paragraph 108(2)(a) in order to avoid having to meet those investment restrictions. The restrictions, which include the requirement that no more than 10 percent of the trust funds be invested in securities of any one entity other than the Crown, are not particularly onerous in most cases, but require continuous monitoring because they must be met throughout each taxation year.[29]

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[28] See, for example, D.W.M. Waters, *Law of Trusts in Canada*, 2d. ed. (Toronto: Carswell, 1984), 10 and 787.

[29] The requirements in paragraph 108(2)(b) are that *throughout* the taxation year in which the status of the trust is relevant, the trust must comply with the following conditions:

(i) it was resident in Canada,

(ii) its *only* undertaking was the investing of funds of the trust,

(iii) at least 80 percent of its property *throughout* the year consisted of shares, bonds, mortgages, marketable securities, cash or rights to or interests in any rental or royalty computed by reference to the amount or value of production from a natural accumulation of petroleum or natural gas in Canada, from an oil or gas well in Canada or from a mineral resource in Canada,

(The footnote is continued on the next page.)

The essential requirement under paragraph 108(2)(a) is that the trust units have conditions that require the trust to accept, "at the demand of the holder thereof" and at prices determined and payable in accordance with the conditions, the surrender of the units. Alternatively, the units may be qualified if they meet prescribed conditions relating to the redemption of the units by the trust; however, no such conditions have been prescribed to date. The wording of paragraph 108(2)(a) raises some doubt as to exactly what is to occur on demand; that is, the provision states only that the trust must be required to accept the unit surrender on demand (and that the price be determined and payable in accordance with the conditions applicable to the units), and does not actually state that the valuation and redemption for surrendered units must also occur on demand.[30] Certainly, the more conservative practice has been to interpret paragraph 108(2)(a) as requiring the unit price to be fixed and the redemption to be triggered on demand.

The question when units are redeemable "at the demand of the holder" has been and continues to be a subject of some debate. In the absence of any alleviating administrative policy, redemption "at the demand of the holder" presumably means (subject, perhaps, to a reasonableness requirement)[31] more or less immediate redemption on the making of a demand,

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[29] Continued . . .

(iv) not less than 95 percent of its income (determined without reference to subsections 49(2.1) and 104(6)) *for* the year was derived from, or from dispositions of, investments described in (iii),

(v) at no time in the year did more than 10 percent of its property consist of shares, bonds or securities of any one corporation or debtor other than Her Majesty in right of Canada or a province or a Canadian municipality, *and*

(vi) where there are prescribed for this purpose conditions relating to the number of its unit holders, dispersal of ownership of its units or public trading of its units, all holdings of and transactions in its units accorded with those conditions [emphasis added].

Note that draft legislation released by the Department of Finance on May 27, 1994 will make it easier for real estate investment trusts (REITs) to qualify as unit trusts by amending paragraph 108(2)(b) to provide that permitted undertakings will include the acquiring, holding, maintaining, improving, leasing, or managing of real property that is capital property of the trust, and by amending subparagraph 108(2)(b)(iii) to include Canadian real property as a permitted investment. The draft legislation also amends the definitions of "mutual fund trust" and "mutual fund corporation" in a consistent manner. The new rules will apply to trusts, provided that the trust units are listed in the year in question or in a following year on a prescribed exchange. See Canada, Department of Finance, *Release*, no. 94-049, May 27, 1994. See also Claude Désy, ed., *Access to Canadian Income Tax* (Markham, Ont.: Butterworths) (looseleaf), paragraph C104-001, regarding the requirement contained in subparagraph 108(2)(b)(iii).

[30] See also the views of the Legislative and Intergovernmental Affairs Branch as reported in *Access to Canadian Income Tax*, supra footnote 29, at paragraph C104-046.

[31] See, for example, the definition of "at," in *Black's Law Dictionary*, 5th ed., and the definition of "on demand," in *Words and Phrases Judicially Defined in Canadian Courts and Tribunals*, vol. 6 (Toronto: Carswell) (looseleaf). However, to the extent that reasonableness depends on, for example, the ability to value fund units on a frequent basis, it is interesting to note that certain US funds value units hourly.

which probably implies frequent if not daily valuations and probably permits no possibility of redemption suspensions. Although Revenue Canada has generally had an alleviating administrative policy, the policy has changed considerably over the years and is still in flux.

It is worth reiterating that where units are offered for sale pursuant to a prospectus, *National Policy Statement* no. 39 provides that there must be at least weekly valuations, except that valuations as infrequent as monthly are permitted with the approval of the unit holders.[32] Revenue Canada will accept a frequency of valuation dates that is in accordance with the national policy statement. Where trust units are not offered for sale pursuant to a prospectus (in which case *National Policy Statement* no. 39 technically does not apply), Revenue Canada's position is less clear. However, Revenue Canada generally appears to accept up to monthly valuations without much difficulty.

Revenue Canada has also shown concern in the past with the terms and conditions on which redemption proceeds are payable. Provisions to the effect that redemption proceeds are payable (following the valuation day after a redemption request is made) on "normal commercial terms" have apparently been problematic, and Revenue Canada generally insists that the trust indenture clearly provide that redemption proceeds will be paid within five business days after the applicable valuation day. This stipulation is consistent with *National Policy Statement* no. 39 in the case of units offered for sale pursuant to a prospectus.[33] Note that Revenue Canada apparently has accepted payment at a discount to market, by way of a three-year unsecured note, in the context of a trust where the trust units were also intended to be listed on an exchange.[34]

Apart from the questions of frequency of valuation days and timely payment of redemption proceeds, the issue whether a trust unit is redeemable on demand may also depend on the existence and wording of a provision in the trust indenture that permits the suspension of unit redemptions. There has been some difficulty in the past in ascertaining a consistent administrative policy on the question whether units can qualify as redeemable on demand where the trust indenture contains such a provision. In part, the problem has been that this issue is dealt with by at least two different groups within Revenue Canada—namely, the Rulings Directorate (Legislative and Intergovernmental Affairs Branch) and the Registered Plans Division. The Registered Plans Division is involved because, where a fund qualifies as a unit trust but not as a mutual fund trust, it is often advisable to register it as a registered investment, as described below.

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[32] Supra footnote 25.

[33] Ibid., at section 13.02(1).

[34] See George Wasserstein, "A Comparison of U.S. and Canadian Tax Rules Relating to Real Estate Investment Trusts," Insight Seminar, March 1994, tab 8, at 25.

At the 1991 tax conference,[35] Revenue Canada was asked its position with respect to the frequency of valuations and the permissibility of provisions for suspending the right of unit holders to redeem their units. It responded that the securities commissions of the various provinces are responsible for policing the issue of mutual fund units. Revenue Canada stated that the "conditions" (implicitly, for the purpose of paragraph 108(2)(a)) that are generally acceptable to the department would be those that conform to the requirements of the appropriate securities commission. It should be noted, however, that this policy statement did not deal directly with the issue of trust units under an offering memorandum. Where trust units are issued under an offering memorandum and not a prospectus, *National Policy Statement* no. 39 does not apply and, furthermore, the applicable securities commissions would not, as a general matter, "police" the issue of the units (indeed, the offering memorandum is generally filed after the offering is completed). Accordingly, this statement of Revenue Canada's administrative policy leaves it uncertain whether trust units offered for sale under an offering memorandum would be considered to "conform to the requirements" of the securities commission (in the sense that the commission simply would not impose substantive requirements on units offered by way of offering memorandum), or whether, more likely, the administrative policy statement simply did not contemplate such offerings.[36]

In the past, the Registered Plans Division has approved of suspension provisions that are in accordance with *National Policy Statement* no. 39. The practice of the division is to send a letter, at the time of confirming registration of a unit trust as a registered investment, that states in part whether the trust qualifies under paragraph 108(2)(a) or paragraph 108(2)(b). Accordingly, assuming that the client does not want a letter on file from Revenue Canada that characterizes the trust as having to meet the investment restrictions under paragraph 108(2)(b), the adviser will need to deal with the Registered Plans Division's interpretation of the "redeemable on demand" requirement. Furthermore, the ultimate relevance of the views of the division is that a unit trust that was registered as a registered investment and is no longer considered to qualify under paragraph 108(2)(a) and does not meet the investment restrictions under paragraph 108(2)(b) could, depending on its basis for registration, find its registration revoked in accordance with subsection 204.4(3) of the Act. In practice, however, it appears doubtful that the Registered Plans Division would initiate revocation without input from the Rulings Directorate. The Rulings Directorate, on the other hand, has apparently been concerned that if there is an indefinite suspension of redemptions, even with the consent of the appropriate

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[35] "Revenue Canada Round Table," in *Report of Proceedings of the Forty-Third Tax Conference*, 1991 Conference Report (Toronto: Canadian Tax Foundation, 1992), 50:1-83, question 6, at 50:4.

[36] See also *Access to Canadian Income Tax*, supra footnote 29, at paragraph C104-053, where Revenue Canada expands on the 1991 tax conference round table statements, supra footnote 35, apparently again in the context of an issue of units policed by a securities commission.

securities regulators, continuing paragraph 108(2)(a) status is not appropriate. (In part, the Rulings position apparently is developing in response to the experience with several real estate funds where redemptions have been suspended for lengthy periods. The specific problems faced by real estate funds in qualifying as unit trusts and mutual fund trusts will be alleviated where such funds can qualify under paragraph 108(2)(b) as amended by draft legislation released on May 27, 1994.)[37]

In recent months, a consistent policy appears to have emerged. In an unpublished ruling in October 1993, the Rulings Directorate peripherally considered provisions for the suspension of unit redemptions where units were offered for sale under an offering memorandum (such that *National Policy Statement* no. 39 technically had no application), but where the trust indenture contained suspension provisions that followed reasonably closely those contained in the national policy statement. Revenue Canada ultimately determined that a new approach was desirable. The rulings given included a ruling to the effect that the redemption suspension provisions would not, in and of themselves, prevent the trust from qualifying under paragraph 108(2)(a) of the Act. However, in a separately stated "opinion" that was not part of the actual rulings, Revenue Canada indicated that if a suspension of unit redemptions actually occurred, the trust might at that time fail to qualify under paragraph 108(2)(a). The letter went on to state, however, that such a suspension would not, in and of itself, cause the trust to cease to qualify as a unit trust or a mutual fund trust for an interim period beginning on the date of the suspension and ending on the first anniversary of the suspension. Furthermore, the Registered Plans Division apparently has now adopted a similar policy.[38]

It is worth emphasizing that Revenue Canada's latest position differs significantly from previous policy, including the position stated at the 1991 tax conference. It is the author's understanding that the new policy will apply to all unit trusts, whether or not units are offered for sale under a prospectus. Accordingly, prior policy statements can no longer be relied on to provide the whole answer. Furthermore, the new policy may be an interim policy pending legislative amendment.[39] In any case, the new policy appears to be that the mere existence of "reasonable" provisions for the suspension of redemptions will not prevent a trust from qualifying under paragraph 108(2)(a), but that on an actual suspension Revenue Canada may view the trust as no longer qualifying under paragraph 108(2)(a) if the suspension lasts for more than one year.

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[37] See supra footnote 29.

[38] In the context of a letter recently received on application for registered investment status of various unit trusts, the Registered Plans Division indicated that if a suspension is actually invoked, it must not extend beyond a one-year period without advice from the department.

[39] As noted in footnote 29, supra, draft legislation addressing problems faced by REITs has recently been introduced.

One might argue that the application of paragraph 108(2)(a) depends not on whether a suspension actually occurs but rather on the conditions attached to the trust units, and that the status of a trust for the purpose of paragraph 108(2)(a) should not change unless those conditions are amended. At the same time, however, Revenue Canada could take the position that a trust that contains any provision for the suspension of redemptions should from the outset be characterized as failing to qualify under paragraph 108(2)(a). The present policy represents a reasonable compromise that, perhaps, is not a strict reflection of the language of paragraph 108(2)(a).

Of course, Revenue Canada's new policy can lead to the result that units that initially qualify for investment within deferred income plans such as RRSPs could become non-qualifying (if a suspension occurs and lasts for more than one year, and the trust therefore ceases to be a unit trust under paragraph 108(2)(a) and for some reason cannot meet the restrictions under paragraph 108(2)(b)), and at the same time the deferred income plan investor may have no opportunity to dispose of the investment because of the suspension.[40] In this scenario, an attempt to list the trust units for trading on a public exchange might be considered[41] or, alternatively, an investor might consider selling the units out of the plan to himself or herself (although that would raise the issue of valuation).

The mutual fund industry as a whole may find it relatively easy to live with Revenue Canada's new policy. It is conceivable that with the threat of a potential recharacterization on the expiration of the one-year "grace period," Revenue Canada will be less concerned with the actual form of the suspension provisions (that is, the question whether the suspension provisions follow precisely the national policy statements—for example, in the case of units offered under an offering memorandum). Furthermore, one may surmise that most mutual fund managers who deal with shares and other normally liquid investments may not be particularly troubled by the potential of a recharacterization by Revenue Canada after the grace period; it is unlikely, at least for a fund invested in North American markets, that a fund that holds shares and other listed investments would have to suspend redemptions for anywhere close to one year.

Mutual Fund Trust

The definition of "mutual fund trust" is contained in subsection 132(6). The trust must, first of all, constitute a unit trust resident in Canada (and

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[40] In this case, a trust governed by a deferred income plan that holds units that no longer constitute a qualified investment would be subject to the monthly penalty tax under part XI.1, but should not suffer a full income inclusion under the provisions applicable to the acquisition of non-qualified investments (because there has been no "acquisition" of a non-qualified investment; the trust merely holds a now non-qualified investment that was a qualified investment when it was acquired).

[41] Note that in the case of a trust that invests in Canadian real property, obtaining such a listing could qualify the trust units under proposed amendments to paragraph 108(2)(b) so that an actual sale of the units may not be necessary. See supra footnote 29.

therefore the previous discussion is relevant), must limit its activities to the investing of its funds,[42] and must comply with prescribed conditions relating to the number of unit holders, the dispersal of ownership of the units, and the public trading of the units. No election is required to qualify as a mutual fund trust.[43]

The prescribed conditions are contained in regulation 4801 and provide basically that

1) a class of the units of the trust must be "qualified for distribution to the public," and

2) in respect of any class of units that are so qualified, there must be at least 150 beneficiaries each of whom holds at least one "block of units" of that class *and* units of that class with a value of at least $500.

These requirements must be met on an ongoing basis, and therefore a margin of error is advisable with respect to the number of qualifying beneficiaries.

With respect to the distribution requirement, the phrase "qualified for distribution to the public" is defined in regulation 4803(2) and will usually require that a prospectus, a registration statement, or a "similar document" has been filed with and, where required by law, accepted for filing by a public authority, and that there has been a lawful distribution to the "public" in accordance with the document. Although these provisions could be construed as denying mutual fund trust status to a trust the units of which are distributed under an offering memorandum, Revenue Canada has in the past interpreted an offering memorandum as a "similar document" and has given at least one private ruling to the effect that a distribution under an offering memorandum filed with the appropriate securities commission would qualify for the purpose of regulation 4801(a).

With respect to the dispersal rules, a "block of units" is defined in regulation 4803(1). The requirement that there be at least 150 beneficiaries of the trust can be problematic where investment in the trust is itself pooled through some other vehicle or plan—for example, another trust. Although the Act in paragraph 108(1)(b) defines a beneficiary under a trust as an individual who is "beneficially interested" in the trust, and in subsection 248(25) defines "beneficially interested" in a broad manner that looks through one or more other trusts, it is not entirely clear that the definition of

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[42] Paragraph 132(6)(b) stipulates that the "only undertaking" of the trust can be the investing of its funds, which may raise an interpretive issue whether ancillary activities are permitted. See, for example, Mark Davis, "Mutual Funds—Current Issues" (October 1989), 6 *Business and the Law* 78-80, at 80.

[43] Note, however, that subsection 132(6) provides that a trust that meets the qualifications of a mutual fund trust within the deadline for filing its first year's tax return can elect in that return to be treated as a mutual fund trust retroactive to the beginning of the year. At one time, Revenue Canada apparently took the position that this election would be insufficient to constitute a unit of the trust as a qualified investment for deferred income plans with retroactive effect; however, Revenue Canada apparently will now accept as "qualified investments" units in those funds that qualify retroactively. See Levine, supra footnote 5, at 14.

beneficiary would apply for the purpose of regulation 4801.[44] Perhaps more important, regulation 4801 refers to beneficiaries each of whom *holds* units. The holding of units most likely connotes direct ownership rather than beneficial interest. Accordingly, for example, hundreds of individuals may be beneficiaries of mutual fund trust A, and yet presumably mutual fund trust A will count as only 1 beneficiary if it in turns invests in mutual fund trust B (and, accordingly, mutual fund trust B must have at least 149 other beneficiaries each of whom has sufficient number and value of units or it cannot constitute a mutual fund trust). For the purpose of these provisions, however, Revenue Canada has ruled privately that each member of a "group RRSP" will be a separate beneficiary for the purpose of determining the status of a trust in which the "group RRSP" invests. Revenue Canada's willingness to look through a "group RRSP" in this manner will probably depend on the particular "group RRSP" structure and, in particular, on the assumption that the "group RRSP" is not itself a single trust but only an administrative grouping of separate trusts for each member. Although this assumption is likely to be valid in the case of most "group RRSP" structures, if the documentation is unclear, a ruling may be advisable in this context.

Trust Units as Qualified Investments

Units of a trust can qualify for investment by a trust governed by an RRSP, a DPSP, or a RRIF in one of three ways:

1) a unit of a mutual fund trust is automatically a qualified investment;[45]

2) an interest in a trust is a qualified investment if the trust was a "registered investment" for the particular plan (that is, RRSP, DPSP, or RRIF) during the calendar year in which the determination is relevant or the immediately preceding year;[46] or

3) where the trust is neither a mutual fund trust nor a registered investment, units of the trust may still be purchased for an RRSP, a DPSP, or a RRIF if the trust constitutes a "qualified trust" and makes an appropriate election.[47]

The requirements for meeting the mutual fund trust definition are discussed above. Where the trust does not meet that definition but trust units

[44] Note that although the definition in paragraph 108(1)(b) applies "in this subdivision" (subdivision k), section 16 of the Interpretation Act (RSC 1985, c. I-21, as amended) provides that expressions used in regulations have the same meaning as in the enactment that confers the power to make the regulations. On this ground, the paragraph 108(1)(b) definition is likely to be imported for the purposes of the regulations, even though the definition is not within the generally applicable definitions in section 248 of the Act.

[45] By virtue of regulation 4900(1)(d).

[46] Regulation 4900(1)(a).

[47] See section 259 of the Act, and the proposed amendments thereto, in Canada, Department of Finance, Draft Amendments to the Income Tax Act, the Canada Pension Plan, the Canada Business Corporations Act, the Excise Tax Act, the Unemployment Insurance Act, and Certain Related Acts, August 30, 1993, clause 110.

are to be sold to deferred income plan investors, a decision must be made whether to register the trust as a registered investment or to proceed as a qualified trust.

Registration as a "registered investment" under section 204.4 of the Act is a convenient way of qualifying units of a unit trust that does not meet the definition of a mutual fund trust for investment within deferred income plans. Once registered investment status is obtained, the investor can take comfort in the fact that trust units will continue to qualify for investment within deferred income plans, because a revocation of registered investment status can occur only on formal notification by the minister of national revenue under subsection 204.4(3) and, if such a notification is made, subsection 204.4(5) of the Act provides for a three-month period during which a deficiency in the qualifications for registered investment status can be cured. In contrast, there is no registration procedure for mutual fund trusts, and mutual fund trust status must be monitored on an ongoing basis—for example, with respect to the number of unit holders. Finally, if a notification of revocation of registered investment status is made and the qualification deficiencies are not cured within the three-month period, regulation 4900(1)(a) nevertheless provides for continued qualified investment status of the trust units for a period of time. The regulation provides that an interest in the trust that was a registered investment for the relevant deferred income plan "during" a calendar year or the immediately preceding year is prescribed to be a qualified investment for that deferred income plan at that particular time. Although the use of the word "during" may create some ambiguity, in the context of what appears to be an alleviating intent it is reasonable to construe the word as "at any time during" (as opposed to "throughout") so that, if registered investment status is formally revoked, the trust units should continue to be qualified investments for the balance of that year and the next calendar year.[48]

There are several different bases on which an application for registered investment status under subsection 204.4(2) can be made, some of which contain significant investment restrictions. Often, the easiest basis for application is that contained in paragraph 204.4(2)(d), which applies to a trust that would be a mutual fund trust except that it does not meet the prescribed conditions relating to mutual fund trusts as set out in regulation 4801. A trust that does not meet those prescribed conditions in regulation 4801 but would otherwise qualify as a mutual fund trust can apply for registered investment status under paragraph 204.4(2)(d), provided that it in turn holds only prescribed investments for the type of plan or fund in respect of which it has applied for registration. For example, such a trust that wishes to be a registered investment for RRSP investors can hold only prescribed investments for RRSPs, which in turn are defined in regulation 4901 as investments that are "qualified investments" for such plans.

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[48] Support for this conclusion, albeit in a different context, can also be found in *Thomson v. MNR* (1946), 2 DTC 812 (SCC) and *Gifford v. MNR*, 91 DTC 953 (TCC).

As an alternative to an application for registered investment status for the trust, units of a trust that does not constitute a mutual fund trust could be held within certain deferred income plans if the trust constitutes a "qualified trust" as defined for the purpose of section 259. Where the trust so qualifies and makes an appropriate election, deferred income plan investors in the trust are treated as acquiring, holding, or disposing of a direct proportionate percentage of the underlying trust property for the purpose of the rules in the Act relating to the acquisition, holding, and disposition of non-qualified investments and the holding of foreign property. In essence, these trusts are looked through for the relevant tax purposes of the deferred income plan investor.[49] However, this implies a certain level of administrative complexity (for example, when the fund disposes of or acquires any property, theoretically it should report to unit holders so that they can determine how their own foreign property limits may be affected). Perhaps due to this administrative complexity, the use of such trusts appears to be rare.

FOREIGN PROPERTY

Quite aside from the issue whether a particular investment is a "qualified investment" for an RRSP or other deferred income plan, there is the overall restriction that a trust governed by a deferred income plan cannot hold more than 20 percent of its assets at cost in "foreign property" without incurring a monthly penalty tax. These rules are contained in part XI of the Act, and section 205 provides that the rules apply to trusts governed by RRSPs, DPSPs, and RRIFs and to other tax-exempt entities. The rules also apply to a registered investment, and this makes a trust that is a registered investment an unsuitable vehicle for a foreign fund (that is, a fund that would normally be expected to have more than 20 percent of foreign property holdings). Accordingly, a US fund, for example, presumably should take the form of a mutual fund trust (assuming that the "qualified trust" route referred to above is not chosen) so that it is not itself subject to the foreign property rules. It should be noted that, because such a mutual fund trust would not be registered as a registered investment, units of the mutual fund trust would themselves constitute foreign property to the investors under paragraph 206(1)(i) (unless, as permitted by regulation 5000, such a mutual fund trust itself limits its investments in foreign property to 20 percent, which of course is generally not appropriate where the fund is set up to hold only foreign investments). Accordingly, units of such a US fund

[49] Note that although the trust is essentially looked through for the purpose of determining how the qualified investment and foreign property rules apply to the unit holders, the trust itself may still be subject to tax under part I of the Act unless all its income is payable to its beneficiaries in each year and appropriate subsection 104(6) deductions are made, or, in the event that the trust holds investments only for registered pension plans or DPSPs, the trust elects to be a "master trust" in accordance with paragraph 149(1)(o.4) of the Act. Where a qualified trust elects to be a master trust, see also the Revenue Canada statements reported in *Window on Canadian Tax* (Don Mills, Ont.: CCH Canadian) (looseleaf), paragraph 1757, regarding the application of part XI tax.

would constitute foreign property and would be taken into account in the computation of the 20 percent limit for, say, a deferred income plan investor.[50]

As noted above, mutual fund trust status in itself qualifies the trust units for investment within deferred income plans, without any requirement that the trust be a registered investment. A mutual fund trust will, however, sometimes become a registered investment in order to provide comfort to unit holders that its units will not constitute foreign property,[51] effectively shifting part of the burden of the foreign property restrictions from the unit holder to the trust.

Distribution and Redemption Considerations

As mentioned above, tax at the trust level can be avoided if for each year the income of the trust, including the taxable portion of capital gains realized by the trust, is paid or payable to the unit holders, or, in the case of a mutual fund trust, if tax arising at the trust level in relation to taxable capital gains can be avoided or refunded to the trust depending on the level of the redemptions of its units. Where a trust has taxable unit holders, however, an element of undue taxation will arise if the trust retains the non-taxable portion of capital gains. This is because the retained funds, as an asset of the trust, increase the unit value and therefore the inherent gain that would be realized by a unit holder on a redemption. A similar problem arises if earnings on investments are retained at the trust level rather than distributed to unit holders. Accordingly, the appropriate tax result (that is, no tax payable by either the trust or the unit holder on what is supposed to be the non-taxable portion of capital gains realized by the trust) is achieved[52] only where the trust also distributes the non-taxable portion of its capital gains to unit holders (thus eliminating these funds as a trust asset), and does so in a manner that is in itself not taxable in the hands of the unit holder recipient and does not reduce his or her adjusted cost base of the units.

The Act permits a trust to distribute the non-taxable portion of capital gains to unit holders in a non-taxable manner where the amount paid or payable to the unit holders includes the total capital gains realized by the trust in the year. Under subsection 52(6), when the unit holder acquires the right to enforce payment of an amount out of a capital gain (or income)

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[50] As an aside, it should be noted that certain tax-exempt investors investing in a mutual fund trust that holds foreign property may be disadvantaged as a result of the potential incidence of US withholding tax to the trust if a direct investment in US securities by such a tax-exempt entity might have been free of withholding tax under article XXI of the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocol signed at Ottawa on June 14, 1983 and the protocol signed at Washington on March 28, 1984.

[51] Or, perhaps, to provide additional comfort as to the qualified investment status of its units for deferred income plan investors (for example, if there is a concern that the dispersal requirements under regulation 4801 may not be met at some time in the future).

[52] For a trust with taxable unit holders.

of the trust, the unit holder is considered to have acquired the right for the purpose of subdivision c at a cost equal to the full amount payable to the unit holder (rather than a lower amount that might otherwise have constituted the cost under section 52), and in most cases the unit holder receives the subsequent payment as proceeds of disposition of that right in an amount equal to its cost. Provided that appropriate designations are made, the distribution by the trust does not result in a reduction in the adjusted cost base of the units or an income inclusion under section 105.[53] In order for subsection 52(6) to apply appropriately, the unit holders must have an enforceable right to payment from the trust in the year the gains are realized. For this purpose, Revenue Canada does not consider the mere right of the unit holder to redeem units on demand to be sufficient,[54] but requires an allocation to be accompanied by a valid resolution or declaration of the trustees whereby the unit holders acquire an irrevocable right to enforce payment in the year, or requires a clause in the trust agreement that confers on unit holders a legal right to enforce payment in the year (this latter method is probably the simplest). A distribution provision in the trust indenture that deals simply with trust income is not likely to be sufficient, because "income" for trust law purposes probably does not include capital gains. The trust indenture should therefore provide specifically for the distribution of net capital gains realized by the trust.

Certain anomalies do arise, however, where capital gains realized by the trust (and, as discussed below, other trust income) are distributed infrequently. Most unit trusts and mutual fund trusts will calculate and distribute capital gains only at year-end, because that is the only time when the trust's capital gain or loss for the year can be determined with finality and the appropriate designations under the Act can be made. A resulting distortion can arise, however, because the capital gain is distributed only to those who are unit holders at year-end. Consider the simple scenario of a trust with two unit holders, A and B, each of whom contributes $500 to the trust at the beginning of a year. The trust earns capital gains of $200 throughout the year. On December 30, one day before the trust makes its capital gains distribution, unit holder A's units are redeemed. At that point, A's units have a value that reflects the capital gains realized or accrued by the trust to December 30, and, accordingly, A realizes a gain on his unit redemption (assume a capital gain) of about $100, which appropriately reflects his economic interest in the underlying investments of the trust. On December 31, however, the trust distributes its entire $200 capital gain to unit holder B, who then has an immediate $200 capital gain but an inherent loss in the value of her units of $100. Note that the distortion could be

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53 See clauses 53(2)(h)(i.1)(A) and (B), paragraph 105(1)(a), and subparagraph 105(1)(b)(ii). Note that pursuant to subparagraph 108(1)(j)(vi), section 105 will in any case be inapplicable to certain trusts. See also the examples outlined in *Interpretation Bulletin* IT-390, August 22, 1977, paragraph 7.

54 IT-390, supra footnote 53, at paragraphs 1(a) and 2(a); and *Interpretation Bulletin* IT-286R2, April 8, 1988, paragraph 8.

reduced where the trust is a mutual fund trust that instead retains capital gains and obtains capital gains refunds.

A more significant distortion, perhaps, would arise in the case of a trust that earns investment income. If the trust in the example above earns $200 of interest income instead of capital gains and distributes the income on December 31, the redemption of A's units on December 30 implies that A has converted $100 of interest income into a $100 capital gain (because the value on December 30 reflects the undistributed interest income), while B receives "additional" income of $100 and a $100 unrealized capital loss inherent in the value of B's units (and, unlike in the earlier example, a subsequent disposition of B's units and recognition of the $100 inherent capital loss cannot be used to offset the "additional" income allocation to B). The distortions will be less significant where a trust makes frequent income distributions. For example, a money market fund will attempt to credit all income daily and thus keep the unit value constant.

The distortions can be particularly pronounced for an investor who becomes a unit holder shortly before a distribution. The investor may become a unit holder on December 30, for example, and receive a significant interest or dividend income distribution the next day (together with an inherent capital loss that may be unusable and that is certainly deferred). These anomalies may suggest that, at least in theory, a portion of a unit holder's redemption proceeds should be viewed as representing the unit holder's share of previously undistributed gains or income of the trust, leaving behind the other unit holders' shares for distribution to them on the normal trust distribution dates. In practice, however, redemption proceeds are invariably treated simply as proceeds of disposition, and the gains and income distributed at normal distribution dates are considered to flow through as such to the distributees.

The tax adviser may be faced with the issue whether and what disclosure of these anomalies is appropriate in the context of a prospectus or an offering memorandum. Judging by the number of communications sent out before year-end by various fund managers, there is a degree of confusion among unit holders concerning year-end distributions. The general rules of disclosure are that a prospectus must provide full, true, and plain disclosure of all material facts relating to the securities proposed to be distributed,[55] and a "material fact" is defined essentially as a fact that could significantly affect the market value of the security. In the context of an offering memorandum in the form set out in applicable securities legislation, again, income tax consequences that are a material aspect of the offering should be disclosed.[56] In relation to the anomalies referred to above, it seems reasonable to consider the test as having been met where the disclosure clearly sets out the tax effects of unit redemptions and of receiving

[55] Ontario Securities Act, supra footnote 16, section 56; and BC Securities Act, supra footnote 16, section 44(1).

[56] See O. reg. 1015, supra footnote 17, section 32(1); and BC Securities Act, supra footnote 16, form 43, item 17.

income and capital gains distributions. The tax disclosure need not, it is submitted, go further and describe how a particular unit holder might be affected; the effect on a particular unit holder will depend significantly on the unit holder's particular circumstances, and it is precisely for this reason that the tax disclosure in a public document almost invariably contains a proviso to the effect that the disclosure is general in nature and that prospective unit holders should consult their own tax advisers. Some tax disclosures have included a statement referring in general terms to the anomalies that may arise.[57]

Management Fees

Management fees can present an issue when the fund manager wants to provide an incentive to substantial investors by effectively charging them a lower management fee. Such a fee reduction could be structured in one of the following ways:

1) the manager could charge its fee directly to the unit holders at rates that vary with the level of investment;

2) the manager could charge a minimum fee to the trust and then charge additional, differential fees directly to unit holders;

3) the manager could charge the normal fee directly to the trust and then rebate amounts to particular significant unit holders;

4) the manager could charge its fee directly to the trust but then pay a rebate to the trust, which the trust in turn pays out to the significant unit holders; or

5) as a minor variation on the previous alternative, the manager could charge the fee directly to the trust, but charge a net fee that takes into account the management fee reduction, and the fund could then distribute to the large investor an amount (out of income or capital) equivalent to that reduction.

In each of these alternatives, the manager will face a threshold issue—namely, the question how to explain to potential investors that not all investors will be treated alike, especially where the presence of large investors in the fund may well be of no particular benefit to the other unit holders. This is essentially a marketing issue, and may be more easily dealt with in a trust provision that sets up a type of "sliding-scale" management fee than in one that merely states that the manager can reduce fees in the manager's discretion. Furthermore, beyond the marketing issue, there may be a more general implication that all units of a class should carry the same rights and restrictions. Again, this issue may be better handled through the use of a predetermined "sliding-scale" management fee reduction than through a reduction in the manager's discretion.

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57 For example: "The issue or redemption of units when the net asset value per unit reflects realized or accrued income or gains that have not been allocated to unit holders results in certain discrepancies in the allocation of income and gains as between those unit holders who are being issued or are redeeming units and other unit holders."

In the alternative described in point 1 above, quite apart from the "optics" of invoicing investors directly as opposed to having a fee that is inherent in net asset value, Revenue Canada takes the view, probably correctly, that management fees paid directly by unit holders are not deductible as investment counsel fees under paragraph 20(1)(bb) of the Act.[58] Paragraph 20(1)(bb) provides that management fees are deductible if they are paid for advice or administrative or managerial services rendered by investment counsel in relation to securities owned by the taxpayer. In the case of the management fee charged by the manager of a pooled fund, it seems likely that most (or all) of the fee relates to the management of the securities held by the fund and not to securities owned by the unit holder. Accordingly, where deductibility is important, this alternative is probably not advisable.[59]

To the extent of management fees charged directly to the unit holders, the tax implications of the alternative described in point 2 are really no different from those described in point 1.

With respect to the alternative described in point 3, the basic concern would be the potential application of paragraph 12(1)(x) and subsection 12(2.1) of the Act. If a management fee rebate received by the unit holder constitutes an "inducement" in respect of the activities of the trust or, perhaps more likely, a reimbursement or a contribution in respect of an expense of the trust, subsection 12(2.1) deems the amount to have been received by the trust as an inducement, a reimbursement, or a contribution for the purpose of paragraph 12(1)(x). Although presumably the trust could then elect to "net" the paragraph 12(1)(x) amount against the management fee payable by the trust, tax deductions would be reduced at the trust level. By implication, those unit holders who do not receive the cash benefit of the management fee rebate would nevertheless indirectly suffer a reduced tax deduction.

The alternatives described in points 4 and 5 are really very similar, except that the latter involves less administration for the manager and is probably more desirable for that reason. The alternative described in point 5 has apparently been adopted by several funds within the last year and has apparently been ruled on favourably by Revenue Canada. A simple example of a fund with two investors illustrates how the alternative operates. Investor A is a "small" investor who bears a normal (say, 2 percent) management fee, and investor B is a large investor who is intended to indirectly bear a management fee of, say, 1.5 percent. Assuming that the trust had net assets over the course of a year of $1,000,000 of which $200,000 was contributed at the beginning of the year by A and $800,000 by B, the manager would charge a fee of $16,000 (2 percent of $200,000 and 1.5

[58] See *Access to Canadian Income Tax*, supra footnote 29, at paragraph C20-1108.

[59] Note, however, that the specific deduction provided in paragraph 20(1)(bb) is irrelevant if the expense is deductible under section 9 as a general expense made for the purpose of gaining or producing income from business or property. See *Interpretation Bulletin* IT-238R2, October 6, 1983, paragraph 5.

percent of $800,000) net to the trust. The trust would then pay $4,000 directly to investor B at some point. Presumably, the cash for this payment would come from normal income of the trust or, if necessary, from asset realizations.

In this example, the cash result appears to be the same as that when management fee rebates are provided directly to investors. The tax result is likely to be that the trust has a deductible expense of the net $16,000 and that investor B has income of $4,000 (or, to the extent that the amount was paid out of the capital of the trust, perhaps a reduction of the tax cost of his units of $4,000). In addition, however, where the payment by the trust is made out of income, the trust should have an additional $4,000 deduction for income payable to unit holder B.

The current practice appears to be to obtain an advance income tax ruling to deal with management fee reductions. The ruling should confirm in part that the structure adopted does not result in the application of subsection 104(7.1) of the Act.

CONCLUSIONS

Trusts that are structured as unit trusts or mutual fund trusts will continue to be reasonably flexible and suitable vehicles for the pooling of passive investments. Although sometimes the status of a particular trust under the Act may initially be ambiguous, Revenue Canada has in the past generally adopted alleviating policy positions (for example, with respect to the question whether units are redeemable on demand). In this environment, tax advisers involved in the creation of unit trusts or mutual fund trusts will usually be able to resolve relevant income tax issues in a manner that allows them to meet the commercial goals of the trust.