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

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The Chair and Members
House of Commons Standing Committee on Finance
Sixth Floor, 131 Queen Street
House of Commons
Ottawa ON K1A 0A6

Dear Committee Members:

RE: 2016 Pre-Budget Consultations

Thank you for the opportunity to present recommendations for inclusion in the 2016/2017 federal budget. Our submission focusses on three specific policy areas: Tax relief for middle class Canadians through GST/HST reform; support for investors and financial services through equitable taxation for mutual fund corporations, and support for retirement savings through reforms to registered savings plans.

GST/HST Reform

Since the introduction of the GST in 1991, most financial services in Canada have been taxed under an exemption system. One notable exception to this rule is mutual funds, whose investors are fully taxed on the entire cost of "producing" a fund. This anomaly is the result of the way in which funds are structured, and of a failure by the 1991 architects of the GST to recognize and address the anomaly. An already inequitable tax burden on investors suddenly doubled when several provinces introduced a harmonized sales tax.

IFIC is asking that the federal government support Canadian savers and restore consistency to the taxation of investment funds by qualifying them for a 100% rebate of the GST paid by the fund, consistent with how other financial services products are taxed. Should revenue considerations preclude this solution, a partial solution would be to apply a pension-type rebate equivalent to 33% of the GST paid by investment funds.

Under Canada's exemption system, investors are not charged tax on the financial products and services they consume and financial services providers cannot claim input tax credits on their taxable supplies. Since most financial products, such as GICs, are manufactured "in house", many of the production costs do not attract GST/HST and the charges to the end consumer include little GST/HST. However, the corporate structures used by most investment funds that enable pooling of investors' funds preclude full "in house" production.

The majority of investment funds in Canada are structured as trusts, with the authority to hire a management company to direct the fund's day-to-day affairs and other required services. The unique structure for investment funds safeguards investors' assets, but this protection comes at an unseen price for the investor.

An investment fund very rarely has employees. Rather, the costs of salaries of fund manager employees are allocated to the different funds that they support through the management fee. The labour is taxable to the fund because the trust stands between the fund manager and fund investor. The investment fund, in turn, makes exempt supplies for GST/HST purposes, i.e., earning and distribution of investment income through dividends, interest, capital gains on trading of financial securities, etc. As suppliers of exempt services, investment funds are not entitled to recover the GST/HST paid to the fund manager, including the GST/HST paid on labour costs embedded in the fees charged by fund managers. This makes 100% of the GST/HST a cost to fund investors, which reduces the net return on their investments.

The result amounts to a tax on savings for those investors who choose investment funds over other financial products in Canada. The introduction of registered plans, combined with falling interest rates are factors have motivated increasing numbers of Canadians to build their personal savings through investment funds. But in doing so, they have unknowingly also incurred a higher tax burden.

A second inequity is triggered by policies that require the HST liability of a fund series to be based on the value of investments held by investors resident in a harmonized province, while the HST expense has to be shared equally by all investors in the series – regardless of their residency. Put simply, investors in non-HST provinces are subsidizing the HST on behalf of investors from harmonized provinces.

As the HST applies to the fund series itself, and not directly to individual investors, those living in Ontario and the other HST jurisdictions may pay a blended rate which is less than the rate that applies to goods and other services in their provinces. Investors in non-HST provinces such as – Alberta, Manitoba, B.C. and Saskatchewan – subject to the blended rate will pay more than the 5% GST applicable in their province.

This inequity is only going to increase as HST provinces search for additional revenue. The Quebec government has raised the QST twice in the last five years; New Brunswick recently announced a 2% increase effective July 1, 2016.

The government has identified stimulating retirement savings and savings for post-secondary education as priorities. Reducing the tax on Canadians who save through investment funds would be an efficient public policy approach to achieve those objectives**.**

A tax rebate provided to the investment fund has the immediate effect of increasing an individual's accumulated savings and enhancing the savings returns, unlike other forms of tax reductions that are provided directly to an individual where the consumer may choose to save or spend the money.

Equitable Taxation for Mutual Fund Corporations

The "General Rate Reduction" should be made available to mutual fund corporations on income other than dividends from taxable Canadian corporations and capital gains in order to achieve a greater degree of "integration" under the Income Tax Act. 'Integration' in the mutual fund corporation context achieves a result whereby the combined taxes payable by a corporation and its taxable shareholders on income earned and distributed would equal the taxes payable if the income had been earned directly by such shareholders.

Investors holding shares of mutual fund corporations are currently being over-taxed because such corporations are not entitled to apply the 13% "General Rate Reduction" to income that is not eligible for another corporate tax reduction – unlike most other corporations in Canada. The Income Tax Act currently provides that the full rate taxable income of a mutual fund corporation is deemed to be nil. Presumably this is because two of the principal types of a mutual fund corporation's income – capital gains and Canadian dividends – are already subject to preferential treatment designed to achieve integration (i.e., the capital gains refund and capital gains dividend mechanisms applicable to capital gains and the deduction in computing taxable income and refundable tax applicable to Canadian dividends).

This would be a reasonable policy if a mutual fund corporation were only to earn capital gains and Canadian dividend income. However, mutual fund corporations may have income from other sources (e.g., interest income and income from foreign sources).The inability to claim the General Rate Reduction on such income means that the corporate tax rate applicable to a mutual fund corporation's interest income and foreign income exceeds that necessary to achieve integration for taxable investors.

To rectify this imbalance, we request that Canadian mutual fund corporations be entitled to apply the General Rate Reduction to all income other than net realized capital gains and dividends that are subject to Part IV tax.

Registered Plan Reforms in Support of Retirement Savings

Savings held in mutual funds represent an important component of Canadians' retirement savings, both individually and through group RRSPs. GRRSPs are an accessible and efficient option within the retirement savings landscape. They fulfil many of the same goals as PRPPs – creating long-term savings through a workplace plan with minimum administration demands on employers that make them particularly appealing to smaller businesses.

Group RRSPs are the pension plan of choice for thousands of Canadian employers. Canadians currently have more than $60 billion invested in Group RRSPs. Group RRSPs, with their often built-in financial advisory components, offer significant benefits over and above their core retirement savings function. Research shows that people who consistently access financial advice accumulate higher levels of wealth than those who are not advised – principally because they develop better savings habits and are more likely to stick to their financial plans. Advised investors also demonstrate higher levels of confidence in their retirement readiness.

Two related aspects of the current rules governing GRRSPs currently detract from their pension-like properties. Both can be addressed through minor changes to the rules. A further rule change would increase the likelihood of employee enrollment.

Locking in of employer contributions: In order for a workplace saving plan to be considered a pension plan by the CRA, the employer contribution must be locked in; however, currently, there is no locking in ability for employer contributions to group RRSPs. The industry supports a change that would require employer contributions to group RRSPs be locked-in.

Exempting employer contributions from payroll tax: Because employer contributions are not locked-in, the CRA treats employer contributions to group RRSPs as deferred income rather than pension contributions. As a result, these contributions are fully subject to payroll tax, discouraging employers from offering an otherwise efficient workplace savings program. Locking in employer contributions and exempting the contributions from payroll tax would encourage adoption of group RRSPs by employers.

Auto-enrollment: Numerous studies in behavioural economics have identified auto-enrollment in retirement savings plans as a powerful way to increase employee participation. A change in the group RRSP rules to enable auto-enrollment similar to PRPPs would help the government attain its goal of getting more Canadians to save for retirement, while further strengthening group RRSPs as an option for employers

We would be pleased to provide additional details on any of the above recommendations.

Yours sincerely,

THE INVESTMENT FUNDS INSTITUTE OF CANADA

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