Income Tax Implications of Joint Investment by Pension Plans Through a Private Pooled Fund Vehicle

Eva M. Krasa*

PRÉCIS

Il est quelquefois souhaitable qu'un groupe de régimes de retraite mette en commun une partie ou la totalité de leurs fonds en vue de placements. Les incidences fiscales canadiennes découlant du groupement par au moins deux régimes enregistrés de retraite pour investir conjointement leurs fonds par l'entremise d'un fonds mis en commun privé structuré comme une fiducie sont examinées dans cet article. Les incidences fiscales sont critiques en ce sens que les avantages pour les régimes de retraite découlant de la mise en commun des fonds peuvent être largement annulés par les répercussions fiscales défavorables.

Il faut tenir compte des limites fiscales suivantes dans le cadre de la structuration du fonds mis en commun :

1) *Restrictions des placements des régimes de retraite*. Bien que les principales limites sur les placements d'un régime de retraite soient contenues dans la législation régissant les pensions et dans la description des politiques et des objectifs de placement du régime, la Loi de l'impôt sur le revenu (Canada) et le Règlement contient certaines règles et limites pertinentes aux placements des régimes de retraite. Les règles sur les biens étrangers contenues dans la partie XI de la Loi, selon lesquelles une pénalité fiscale est imposée lorsque, à la fin d'un mois donné, le coût indiqué des biens étrangers d'un régime enregistré de retraite excède le total de 20 pour cent du coût indiqué du total de ses biens et trois fois le montant du placement dans des petites entreprises, sont particulièrement importantes. Selon la définition du terme «bien étranger», toute participation dans une fiducie constitue un bien étranger à moins qu'une exception spécifique ne s'applique. Les exceptions comprennent les suivantes :

a) une participation dans une «fiducie de fonds mis en commun» (comme elle est définie dans le règlement 5000(7)), pourvu que le contenu en biens étrangers de la fiducie de fonds mis en commun n'excède pas le plafond de 20 pour cent;

* Of Borden & Elliot, Toronto. The author acknowledges, with appreciation, the comments on this article provided by Laura White of Borden & Elliot.

b) une participation dans une fiducie principale au sens de l'alinéa 149(1)o.4), pourvu que le bénéficiaire du régime de retraite ou la fiducie principale ne possède pas de biens étrangers;

c) une participation dans une fiducie qui est un placement enregistré; et

d) une participation dans une fiducie qui serait une fiducie quasi de fonds commun de placement (comme elle est décrite dans le règlement 5000(1)c)), pourvu que le contenu en biens étrangers de la fiducie quasi de fonds commun de placement n'excède par le plafond de 20 pour cent.

2) *Possibilité d'imposition du fonds mis en commun*. Puisqu'un régime enregistré est exonéré de l'impôt de la partie I, tout impôt de la partie I payable au niveau du fonds mis en commun représente un coût pour le régime de retraite que ce dernier n'aurait pas engagé s'il détenait directement les placements sous-jacents. Par conséquent, le fonds mis en commun doit être structuré de sorte qu'il profite d'une exemption spécifique de l'impôt de la partie I ou qu'il puisse éviter cet impôt en distribuant son revenu aux régimes de retraite. Même si la totalité du revenu de la fiducie est distribuée aux régimes de retraite, la fiducie peut, dans certaines circonstances, devoir payer l'impôt minimum de remplacement. De plus, il faut tenir compte de la possibilité de l'impôt en vertu de la partie XII.2, selon laquelle un impôt spécial de 36 pour cent est levé dans certaines circonstances. Si les seuls bénéficiaires de la fiducie depuis la formation ont été des régimes enregistrés de retraite, l'impôt de la partie XII.2 ne s'appliquera pas à la fiducie. Cependant, si la fiducie investit à son tour dans une autre fiducie, l'impôt de la partie XII.2 pourrait devoir être payé par la dernière fiducie. Enfin, le fonds mis en commun peut, selon sa nature, être assujetti aux règles sur les biens étrangers ou à une pénalité fiscale en vertu de l'article 206.1.

Étant donné les limitations fiscales, les régimes enregistrés de retraite cherchant à investir conjointement leurs fonds sans que le placement soit traité comme un bien étranger disposent de peu de choix. Le fonds mis en commun sera généralement structuré selon un des quatre genres de fiducies décrites précédemment, lesquelles échappent au filet des règles sur les biens étrangers. Chacune de ces fiducies est examinée en détail dans l'article.

ABSTRACT

It is sometimes desirable for a group of pension plans to pool some or all of their funds for purposes of investment. This article considers the Canadian income tax implications of two or more registered pension plans' investing their funds jointly through a private pooled fund vehicle structured as a trust. The income tax implications are critical in that the benefits to be derived by pension plans from the pooling of their funds can be far outweighed by adverse tax consequences.

The following income tax limitations must be taken into account in structuring the pooled fund vehicle:

1) *Pension plan investment restrictions*. While the main limitations on a pension plan's investments are contained in the governing pension legislation and in the plan's own statement of investment policies and goals, the Income Tax Act (Canada) and the Regulations do contain certain rules and limitations relevant to pension plan investments. Of particular concern are the foreign property rules in part XI of the Act, which impose a penalty tax where, at the end of any month, the cost amount of a registered pension plan's foreign property exceeds the aggregate of 20 percent of the cost amount of all of its property and three times its small business investment amount. Under the definition of "foreign property," *any* interest in a trust constitutes foreign property unless a specific exception applies. The exceptions include the following:

a) an interest in a "pooled fund trust" (as defined in regulation 5000(7)) provided that the foreign property content of the pooled fund trust does not exceed the 20 percent limit;

b) an interest in a paragraph 149(1)(o.4) master trust provided that either the pension plan beneficiary does not own any foreign property or the master trust does not own any foreign property;

c) an interest in a trust that is a registered investment; and

d) an interest in a quasi mutual fund trust (as described in regulation 5000(1)(c)) provided that the foreign property content of the quasi mutual fund trust does not exceed the 20 percent limit.

2) *Potential for tax at the pooled fund level*. Since a registered pension plan is exempt from part I tax, any part I tax payable at the pooled fund level represents a cost to the pension plan that it would not have incurred had it held the underlying investments directly. Accordingly, the pooled fund vehicle must be structured so that it either enjoys a specific exemption from part I tax or effectively avoids such tax by passing its income through to the pension plan investors. Even though all of the income of the trust is passed through to the pension plans, in some circumstances the trust may be liable for alternative minimum tax. As well, account should be taken of the potential for tax under part XII.2, which imposes a special 36 percent tax in certain circumstances. Provided that the only beneficiaries of the trust since its inception have been registered pension plans, part XII.2 tax will not apply to the trust. However, if the trust in turn invests in another trust, part XII.2 tax could be payable by the bottom trust. Finally, the pooled fund vehicle itself, depending on its nature, may be subject to the foreign property rules or to a penalty under section 206.1.

Given the income tax limitations, registered pension plans seeking to invest their funds jointly without having the investment treated as foreign property have a limited number of options. The pooled fund vehicle will generally be structured as one of the four types of trusts described above that can fall outside the foreign property net. Each of these trusts is discussed in detail in the article.

INTRODUCTION

It is frequently desirable for a group of pension plans to pool some or all of their funds for purposes of investment. This article considers the Canadian income tax implications of two or more pension plans' investing their funds jointly through a private pooled fund vehicle. The income tax implications are critical in that the benefits to be derived by pension plans from the pooling of their funds can be far outweighed by adverse tax consequences.

This article is confined to pooled funds that are owned entirely by pension plans and are of a private, closely held nature, as opposed to mutual fund trusts and other funds offered publicly by way of prospectus. It is also assumed that each of the pension plans investing through the pooled fund vehicle is a registered pension plan within the meaning of the Income Tax Act (Canada)[1] and that the pooled fund vehicle constitutes a trust.

There are a number of circumstances in which a private pooled fund vehicle for pension plan investment is used. Investment managers marketing an investment product to the pension fund sector sometimes do so through an intermediary pooled fund vehicle rather than have each pension plan own a direct interest in each of the underlying investments. As well, many of Canada's larger corporations sponsor multiple registered pension plans; and within a related group of corporations, there may be multiple pension plans. For the sake of administrative ease and in order to simplify investment-monitoring responsibilities and achieve economies of scale, these plans may wish to use a pooled fund vehicle to pool some or all of their funds for purposes of investment.

INCOME TAX LIMITATIONS IN STRUCTURING THE POOLED FUND VEHICLE

Complying with Pension Plan Investment Restrictions

Registered pension plans are not subject to the "qualified investment" rules of the Act applicable to registered retirement savings plans (RRSPs), registered retirement income funds (RRIFs), and deferred profit-sharing plans (DPSPs). The main limitations on a pension plan's investments are contained in the governing pension legislation and in the plan's own statement of investment policy and goals.[2] The Act and the Income Tax

[1] 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.

[2] Readers are cautioned that the governing pension legislation and the pension plan's own statement of investment policy and goals should be carefully considered in the context of any investment by the pension plan in a pooled fund vehicle. The federal jurisdiction and most provinces (including Ontario and, most recently, Alberta) have adopted a "prudent portfolio" or "prudent person" approach. This approach gives broad flexibility to pension plans in investing their assets, subject to certain restrictions. Pension plans in these "prudent portfolio" jurisdictions are permitted to invest their assets in pooled funds. The investments made by the pooled fund must comply with the investment provisions of the relevant statute if the pension plan invests more than 10 percent of its assets in the pooled fund.

Regulations do, however, contain certain rules and limitations relevant to pension plan investments:

1) Regulation 8502(h) requires that a pension plan's investments not include a "prohibited investment" under regulation 8514(1) or any investment not permitted under the pension legislation governing the plan. The "prohibited investment" definition in regulation 8514 is designed to prevent a registered pension plan from investing in securities of the employer or of certain other persons connected with the employer. Exceptions are provided for, among other things, publicly traded shares and debt of publicly traded companies. The prohibited investment rules are similar to the restrictions on related-party investments in the pension benefits legislation of most jurisdictions.

2) Section 206.1 of the Act levies a penalty tax in specified circumstances where certain taxpayers, including a registered pension plan, enter into an agreement to acquire a share of a corporation (otherwise than from the corporation) at a price that may differ from the fair market value of the share at the time it may be acquired. This provision is of particular concern in the context of security lending transactions. It does not apply to publicly listed options.

3) The foreign property rules in part XI of the Act impose a penalty tax where, at the end of any month, the cost amount of a registered pension plan's foreign property exceeds the aggregate of 20 percent of the cost amount of all of its property and three times its small business investment amount.[3]

With respect to 1 above, assuming that the pension plan's investment in the pooled fund vehicle does not run afoul of the governing pension legislation, it will likely satisfy regulations 8502(h) and 8514. As a result, the rules described in 1 do not, in and of themselves, pose any special challenge as regards the investment by registered pension plans through a pooled fund vehicle. The same is true of the provisions of section 206.1 described in 2 above. The foreign property rules referred to in 3 above, on the other hand, require careful consideration, and the pooled fund vehicle must be structured to avoid an unexpected liability for the penalty tax levied on excess foreign property holdings. A detailed review of the foreign property rules is beyond the scope of this article.[4] For present purposes, it is sufficient to note the circumstances in which an interest in a trust may constitute foreign property.

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[3] The term "small business investment amount" is defined in subsection 206(1) to be the average of the cost amounts of the plan's "small business properties" (also defined in subsection 206(1)) at the end of the three preceding months. This provision in essence permits a plan to increase its foreign property room on a 3-for-1 basis by investing in small business.

[4] Readers interested in a more in-depth discussion of the foreign property rules may wish to refer to Chris Keys, "Foreign Property: A Short Course," International Tax Planning feature (1992), vol. 40, no. 2 *Canadian Tax Journal* 400-11.

The definition of "foreign property" is contained in subsection 206(1) of the Act. By virtue of paragraph (i) of the definition, foreign property includes *any* interest in a trust unless a specific exception applies. In other words, the fact that the underlying property of the trust is predominantly Canadian does not necessarily mean that an interest in the trust escapes the foreign property net. The exceptions to the general rule that an interest in a trust constitutes foreign property include the following:

- an interest in a "pooled fund trust" (as defined in regulation 5000(7)), provided that the cost amount to the pooled fund trust of its foreign property does not exceed 20 percent of the cost amount to it of all of its property;

- an interest in a trust that elects to be a master trust under paragraph 149(1)(o.4) of the Act, provided that either the pension plan beneficiary does not own any foreign property or the master trust does not own any foreign property (that is, foreign property may be held either at the pension plan level or at the master trust level, but not both);

- an interest in a trust that is a registered investment under section 204.4 of the Act; and

- an interest in a quasi mutual fund trust (as described in regulation 5000(1)(c)), provided that the cost amount to the quasi mutual fund trust of its foreign property does not exceed 20 percent of the cost amount to it of all of its property.

Avoiding Tax at the Pooled Fund Level

It is important that the pooled fund vehicle be structured so that it either enjoys a specific exemption from part I tax or effectively avoids part I tax by passing its income through to the registered pension plan investors. Since a registered pension plan is exempt from part I tax, any part I tax payable at the pooled fund level represents a cost to the pension plan that it would not have incurred had it held the underlying investments directly.

Even though all of the income of a trust is passed through to the registered pension plans, it is possible, in certain limited circumstances, for the trust to be liable for the alternative minimum tax provided for in sections 127.5 to 127.55 of the Act. Because of the mechanics of calculating the alternative minimum tax, a trust may become liable for such tax where its deductible expenses are greater than its gross income other than its taxable capital gains. In other words, alternative minimum tax may be payable where the trust's interest and dividend income is less than its deductible expenses, such as management expenses and custodial fees. As a practical matter, the concern arises in the context of funds whose primary objective is high capital appreciation. (Pursuant to paragraph 127.52(1)(d), the full amount of capital gains is included in adjusted taxable income. The deduction available under paragraph 127.52(1)(g) will not provide a full offset for the capital gains inclusion where less than the full amount of the taxable capital gain is included in the beneficiaries' income, as would be the case where the trust's expenses exceed its other types of income.)

As well, account should be taken of the potential for tax under part XII.2 of the Act. Part XII.2 imposes a special 36 percent tax on distributions by certain trusts out of "designated income." "Designated income" includes income from businesses carried on in Canada, Canadian real properties, Canadian resource properties, and timber resource properties, and gains from dispositions of taxable Canadian property. Pursuant to subsection 210.3(1), a trust will not incur part XII.2 tax in a year if it has no "designated beneficiaries" (as defined in section 210) in that year. Where registered pension plans have been the only beneficiaries of the trust since its inception, the trust will have no designated beneficiaries and part XII.2 tax will not apply to the trust. However, part XII.2 tax could become an issue if the pooled fund vehicle in turn invests in another trust (that is, in a fund-on-fund situation). In these circumstances, part XII.2 tax could be payable by the bottom trust. This is because the pooled fund vehicle itself, depending on how it is structured, could be considered a designated beneficiary of the bottom trust pursuant to paragraph 210(d).[5]

Finally, the pooled fund vehicle itself, depending on its nature, may be subject to the foreign property rules and hence subject to penalty tax if its foreign property holdings exceed the permitted limit. In some circumstances, the penalty tax may be intentionally incurred if it is perceived that the return on the foreign property investments net of the penalty tax is attractive enough, but generally it will be desirable to avoid the tax.

STRUCTURING THE POOLED FUND VEHICLE: VIABLE OPTIONS

Given the income tax limitations discussed in the previous section, registered pension plans seeking to invest their funds jointly without having the investment treated as foreign property have a limited number of options. The pooled fund vehicle will generally be structured as one of the trusts described above that can fall outside the foreign property net; that is, it will take the form of one of the following:

- a regulation 5000(7) pooled fund trust;
- a paragraph 149(1)(o.4) master trust;
- a registered investment under section 204.4; or
- a regulation 5000(1)(c) quasi mutual fund trust.

The remainder of this article is devoted to a discussion of these options.[6]

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[5] By virtue of subparagraph 210(d)(iii), "designated beneficiary" includes a trust resident in Canada if a beneficiary of the trust is itself a trust. If the pooled fund vehicle were structured as, say, a regulation 5000(7) pooled fund trust, it would be considered a designated beneficiary of another trust in which it invests since its own beneficiaries are pension plan trusts. The issue does not arise if the pooled fund vehicle is structured as a paragraph 149(1)(o.4) master trust since there is an exception for trusts that are exempt from part I tax pursuant to subsection 149(1).

[6] There are, in fact, some other options. Where the underlying property of the trust is resource property, a resource property trust (regulations 5000(l)(c.1) and 5000(7)) may be

(The footnote is continued on the next page.)

Regulation 5000(7) Pooled Fund Trust

Pursuant to regulation 5000(1), an interest in a pooled fund trust (as defined in regulation 5000(7)) does not constitute foreign property to a registered pension plan provided that the cost amount to the pooled fund trust of its foreign property does not exceed 20 percent of the cost amount to it of all of its property. There are therefore two issues to be addressed in this context. First, does the trust satisfy the definition of "pooled fund trust" in regulation 5000(7)? Second, has the trust restricted its foreign property content so as not to exceed the 20 percent limit? Each of these issues is discussed below, followed by discussions of the taxation of a regulation 5000(7) pooled fund trust and the advantages and disadvantages of using such a trust.

Qualifying as a Regulation 5000(7) Pooled Fund Trust

In order for a trust to qualify as a regulation 5000(7) pooled fund trust, the trustee of the trust must be a trust company incorporated under the laws of Canada or a province and the trust must meet certain asset and income limitation tests. The asset limitation tests require that

1) 80 percent of the cost amount to the trust of its property is attributable to shares, property that is convertible into shares or confers a right to acquire shares, bonds, mortgages, marketable securities, cash, life insurance policies in Canada,[7] annuity contracts issued by persons licensed to carry on an annuities business in Canada, and income-producing real property ("the 80 percent of assets test");

2) the cost amount to the trust of securities of any one corporation or debtor (other than government securities) does not exceed 10 percent of the cost amount of all of its property; and

[6] Continued . . .
of assistance. For investment in Canadian small business, a small business investment trust (regulation 5103) may be appropriate. In limited circumstances, the Act also accommodates the use of a corporation as an intermediary vehicle for holding pension plan investments. Certain corporations owned entirely by pension plans (or certain other entities) are exempt from tax under part I and from the large corporations tax under part I.3. These corporations are pension real estate investment corporations (subparagraph 149(1)(o.2)(ii)), pension resource property investment corporations (subparagraph 149(1)(o.2)(ii.1)), mini pension fund corporations (subparagraph 149(1)(o.2)(iii)), and small business investment corporations (paragraph 149(1)(o.3)). Discussion of these vehicles is beyond the scope of this article. For an in-depth review of pension real estate investment corporations, see Joel Shafer, "Investments in Real Estate by Tax-Exempt Entities and Intermediaries," in *Real Estate Transactions: Tax Planning for the Second Half of the 1990s*, 1995 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1996), 13:1-17; and Eva M. Krasa, "Pension Real Estate Investment Corporations: Compliance Issues" (1995), vol. 43, no. 3 *Canadian Tax Journal* 610-38. For a discussion of mini pension fund corporations, see Stephen S. Heller, "Financing by Canadian Pension Plans," in *Income Tax Considerations in Corporate Financing*, 1986 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1986), 328-84.

[7] The term "life insurance policy in Canada" is defined in subsections 248(1) and 138(12).

3) the cost amount to the trust of any one real property does not exceed 10 percent of the cost amount of all of its property.

The income test requires that at least 95 percent of the income of the trust be derived from, or from the disposition of, investments described in 1 above ("the 95 percent of income test").

The trust must comply with these tests throughout its taxation year in which the pension plan acquires its interest in the trust (the "first relevant year") or throughout the first taxation year of the trust commencing more than one year after the pension plan acquired its interest (the "second relevant year"). An interest acquired in a trust that satisfies the above-described asset and income limitation tests throughout the first relevant year or the second relevant year will not cease to qualify as an interest in a regulation 5000(7) pooled fund trust if, in some other year, the trust goes offside. An interest acquired in a trust that does not satisfy these tests in either the first relevant year or the second relevant year can never qualify as an interest in a regulation 5000(7) pooled fund trust. Accordingly, a pension plan that invests in the trust at different points in time can be in the position of holding units in a trust some of which qualify as units of a regulation 5000(7) pooled fund trust and some of which do not.

The 80 percent of assets test and the 95 percent of income test merit comment and are discussed in turn below.

Eighty Percent of Assets Test

Difficult definitional issues can arise in the context of the 80 percent of assets test. Of particular concern are the terms "marketable securities," "bonds," "cash," and "annuity contracts," which do not have a precise meaning. These terms are considered below.

1) "Marketable Securities"

Neither "security" nor "marketable security" is defined in the Act. The term "security" appears to have a broad meaning, but "marketable security" has the potential to be very restrictive.

The meaning of "securities" has been the subject of judicial comment. In *Canadian & Foreign Securities Co. Ltd. v. MNR*,[8] it was held that "securities as used in [a former provision of the Act] must be construed in a popular sense."[9] In the case of *P.-Y. Charron et al. v. MNR*,[10] the court held that the term "security" in the Act should be interpreted broadly and that it was appropriate to take account of the definition of "security" in provincial securities legislation. In this regard, it is noteworthy that the

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[8] [1972] CTC 391 (FCTD).

[9] Ibid., at 394. See also *MNR v. Manitou-Barvue Mines Ltd.*, [1965] CTC 534 (Ex. Ct.). Revenue Canada has accepted this inclusive definition of "security": see paragraph 4 of *Interpretation Bulletin* IT-98R2, February 10, 1995.

[10] [1987] 1 CTC 2135 (TCC).

definition of the term "security" under the Securities Act (Ontario)[11] is extremely broad and includes any document, instrument, or writing commonly known as a security.

The term "marketable security" is more problematic. *The Dictionary of Canadian Law*[12] defines marketable security as "[a] security which may be sold on a stock market," but this appears to be an unduly narrow definition. *Black's Law Dictionary*, sixth edition provides the following definition of "marketable securities":

> Stocks and bonds held of other companies that can be readily sold on stock exchanges or over-the-counter markets and that the company plans to sell as cash is needed. Classified as current liquid assets and as part of working capital.

In the 1996 Canadian securities course materials, published by The Canadian Securities Institute, "marketable" is defined as easily bought or sold,[13] and "marketability or liquidity" is defined as meaning that there are "at nearly all times . . . buyers at some price level for the securities."[14]

The meaning of "marketable security" has also been addressed by Revenue Canada. In Revenue Canada's view,[15]

• the term "marketable security" refers generally to a security that is capable of reasonably prompt conversion into cash and that is easily traded because a ready market exists and there are no legal or other impediments to its trade;

• it is always a question of fact whether or not a particular security is a marketable security; and

• the word "market" need not be confined to a stock exchange or over-the-counter market, but when used in the context of "marketable securities," "market" refers to a place in which there are buyers and sellers and in which the security can be readily traded.

Revenue Canada has commented on certain specific types of investments, including units of an open-end trust and futures and forward contracts. With respect to units of an open-end trust, Revenue Canada has stated that such a unit will not be a marketable security solely on the basis that it is redeemable on demand—that is, the redemption feature does not, of itself, create a market in which the unit can be freely traded.

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[11] RSO 1990, c. S.5, as amended.

[12] Daphne A. Dukelow and Betsy Nuse, *The Dictionary of Canadian Law*, 2d ed. (Toronto: Carswell, 1995).

[13] The Canadian Securities Institute, *The Canadian Securities Course* (Toronto: the institute), at Gls-11.

[14] Ibid., at 1-7.

[15] See, for example, the technical interpretation issued by the Rulings Directorate, Financial Industries Division, in Revenue Canada Views [database online], document no. 9311545, July 28, 1993.

If such a unit is non-transferable, it will probably not qualify as a marketable security. If the unit is transferable, it is a question of fact whether or not it is a marketable security.[16] As regards futures contracts, Revenue Canada has expressed the view that exchange-traded stock index futures, bond futures, interest rate futures, and commodity futures normally constitute marketable securities.[17] Revenue Canada has not stated its position with respect to forward contracts, other than to reiterate its general position that the determination is a question of fact and that a particular investment will be considered a marketable security if it can be converted readily into cash, it can be easily traded because a ready group of buyers exists, and there is no legal or other impediment to its sale.[18]

2) "Bonds"

The term "bond" is not defined in the Act and does not appear to have a standard legal definition. In *MNR v. Peninsular Investments Ltd.*,[19] Thurlow J referred to bonds as having the following attributes:

- formalized by a written instrument;
- establishing a fixed time for repayment and a fixed rate of interest;
- ordinarily secured in some manner; and
- relating to the acquisition by the issuer of capital assets or the raising of capital to be employed in the business, as opposed to indebtedness incurred in the day-to-day transactions of the business.

Other definitions suggest that the term "bond" is, strictly speaking, limited to obligations of government or large public corporations and that, except in the case of government bonds, assets are pledged as security for a bond.[20] As well, the Act often refers separately to "bonds,"

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16 Ibid. Note, however, the case of *G. Chappel v. MNR* (1964), 34 Tax ABC 374, in which the Tax Appeal Board, in a different context, held that debentures issued by a township constituted marketable securities.

17 Technical interpretation issued by the Income Tax Rulings and Interpretations Directorate, in Revenue Canada Views [database online], document no. 9500895, April 18, 1995.

18 Technical interpretation issued by the Rulings Directorate, Financial Industries Division, in Revenue Canada Views [database online], document no. 9401165, January 26, 1994. It should be noted that in the context of the 80 percent of assets test, the question whether a futures or forward contract is a marketable security is of little relevance since futures and forward contracts will generally have a nominal cost amount at the time they are entered into. The question is relevant, however, in the context of the 95 percent of income test if a fund derives more than 5 percent of its income from futures or forward contracts.

19 63 DTC 1149 (Ex. Ct.).

20 See the descriptions of "bond" in the 1996 Canadian securities course materials, supra footnote 13, at Gls-2 and 5-2. See also *The Dictionary of Canadian Law*, supra footnote 12, which quotes the following definition of "bond" from *Fraser's Handbook on Canadian Company Law*, 7th ed., H. Sutherland, D.B. Horsley, and J.M. Edmiston, eds.

(The footnote is continued on the next page.)

"debentures," and other forms of indebtedness in the same provision,[21] suggesting that "bond" has a meaning different from "debenture" and other types of debt. Accordingly, it should not be assumed that any debt obligation will qualify as a "bond."

3) "Cash"

The Act does not provide a definition of "cash." In *Air Canada v. Minister of Finance for British Columbia*,[22] the issue was whether bank certificates of deposit were "cash on deposit." Moneys invested under a certificate of deposit were repayable by the bank at the end of a designated term, and if they were withdrawn by the customer before maturity, the interest rate dropped. The court noted that "a certificate of deposit is not transferable or assignable and does not permit orders to be drawn upon it in favour of others. It is not a negotiable instrument."[23] In contrast, a cash deposit has the attributes of "ready availability" and "use in exchange," and there are no "documentary indicia . . . other than a ledger or computer entry and perhaps a simple receipt."[24] The court concluded that the certificates were not "cash on deposit." It also noted that "cash" is limited to "current coin of the realm and bank notes."[25]

Dictionary definitions of "cash" also suggest a relatively narrow meaning. For example, *Black's Law Dictionary*, sixth edition defines cash as

> [m]oney or the equivalent; usually ready money. Currency and coins, negotiable checks, and balances in bank accounts. That which circulates as money.

Revenue Canada has stated that, in its view, cash includes a deposit with a bank or trust company, provided that the depositor has the right to withdraw the money on deposit at any time. A margin deposit with a broker may be considered a cash deposit if it is left in that form for only a short period (one or two days) but otherwise would, in Revenue Canada's view, be considered a debt security.[26]

4) "Annuity Contracts"

The term "annuity contract" is not specifically defined in the Act, although there is a definition of "annuity." Subsection 248(1) defines annuity to include

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20 Continued . . .
(Toronto: Carswell, 1985): "Government obligations which are ordinarily unsecured and obligations of large public corporations." *Black's Law Dictionary*, sixth edition, however, states that "bond" is sometimes used broadly to refer to unsecured debt instruments. A similar comment is made in the Canadian securities course materials.

21 See, for example, paragraph 20(1)(f), subsection 16(2), and regulation 4900(1).

22 *Air Can., etc. [BC]*, [1981] 2 WWR 97 (BC CA).

23 Ibid., at 99.

24 Ibid., at 99-100.

25 Ibid., at 101.

26 Supra footnote 17.

an amount payable on a periodic basis whether payable at intervals longer or shorter than a year and whether payable under a contract, will or trust or otherwise.

The definition of "annuity" contemplates that the right to an annuity and the terms thereof are provided for under a contract or other instrument. Presumably, therefore, an annuity contract is something that provides for the payment of an annuity. In the *Coopérants Mutual Life Insurance Society* case,[27] the Quebec Court of Appeal was required to consider, for purposes of establishing the priority of creditors on the winding up of Les Coopérants, whether certain so-called deferred annuity contracts constituted an "annuity contract." The deferred annuity contracts at issue took several different forms, but each comprised an accumulation phase and a payout phase. The sum total of payments made by the annuitant during the accumulation phase and accrued interest were valued at a stipulated maturity date, at which time the annuitant had the right to begin receiving annuity payments. (In some cases, the amount of the annuity was guaranteed at the beginning of the accumulation phase.) The annuitant could, however, before the commencement of the payout period, withdraw the accumulated amount (and hence never actually receive any periodic annuity payments).

The Quebec Court of Appeal, confirming the decision of the Quebec Superior Court, held that the deferred annuity contracts were true annuity contracts entitled to priority under the Winding Up Act.[28] The fact that the annuitant could redeem at any time before the commencement of the payout period did not change the legal nature of the contract.

On the basis of the *Coopérants* case, it is arguable that once an insurer is bound by contract to issue an annuity at the end of the accumulation phase, an annuity contract exists for the entire period of the contract, which includes the accumulation phase as well as the payout phase. This raises some interesting planning opportunities. As discussed above, not all debt obligations qualify as a "bond." In economic terms, a deferred annuity that is redeemed at the end of the accumulation phase and before the commencement of the payout phase is similar to debt. Accordingly, where the trust wishes to invest in debt that may not qualify as a bond (or as a marketable security or a mortgage), consideration could be given to structuring the arrangement as a deferred annuity.[29]

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[27] *Coopérants Mutual Life Insurance Society (Re. provisional liquidator of)*, [1993] QJ No. 1203 (CA).

[28] RSC 1985, c. W-11, as amended.

[29] Any investment by a regulation 5000(7) pooled fund trust in an annuity contract should take account of the proposed amendments announced by the Department of Finance on December 19, 1996. Under these proposals, an interest in an annuity contract will constitute foreign property if the annuity contract is a segregated fund policy and more than 20 percent of the segregated fund's assets are foreign property.

Ninety-Five Percent of Income Test

With respect to the 95 percent of income test, which requires that 95 percent of the trust's income be derived from, or from the disposition of, investments that qualify for the 80 percent of assets test, the following points are worthy of note:

• The 95 percent of income test is of particular concern in the context of derivative products. Many derivatives have only a nominal cost amount and are therefore not a concern in the context of the 80 percent of assets test; but if they generate significant income, the trust may go offside as a result of the 95 percent of income restriction.

• Revenue Canada has stated that amounts received by the trust from the lending of securities pursuant to a securities lending arrangement are considered amounts "derived" from the securities for purposes of the 95 percent of income test.[30] Accordingly, if the securities that are loaned qualify for purposes of the 80 percent of assets test, amounts received under the arrangement are qualifying amounts for purposes of the 95 percent of income test.

• Revenue Canada has stated that "income" means net income, not gross income, and includes the gross-up amount in respect of taxable dividends (unless the trust makes a subsection 104(19) designation, in which case both the dividend and the gross up are included in the income of the particular beneficiary to which the designation relates). Expenses of the trust are to be applied to the income to which they relate, and those that relate to more than one source of income are to be apportioned on some reasonable basis to the applicable sources of income of the trust.[31]

Satisfying the Foreign Property Limits

A regulation 5000(7) pooled fund trust is not itself subject to the provisions of part XI of the Act; that is, a pooled fund trust is not subject to any penalty tax if its foreign property holdings exceed 20 percent. Pursuant to regulation 5000(1), however, units in a regulation 5000(7) pooled fund trust are not foreign property to a registered pension plan for a particular month only if during the "relevant period for the particular month" the foreign property holdings of the pooled fund trust do not exceed the 20 percent limit. Several points are noteworthy in this regard:

• The ability of registered pension plans (and certain other entities subject to part XI) to increase their foreign property room on a 3-for-1 basis by investing in small business properties does not apply to regulation 5000(7) pooled fund trusts for purposes of determining whether their units constitute foreign property to investors.

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[30] Technical interpretation in Revenue Canada Views [database online], document no. May 1991-116, May 1991.

[31] Technical interpretations issued by the Rulings Directorate, Financial Industries Division, in Revenue Canada Views [database online], document no. 9324505, September 13, 1993 and document no. 9326915, September 22, 1993.

• The pooled fund trust must comply with the foreign property limits at all times during the "relevant period for the particular month." The "relevant period for the particular month" is the trust's most recent taxation year ending before the end of the particular month for which the registered pension plan is determining its compliance with the foreign property limits. In other words, in determining whether as at the end of, say, March 1997 a registered pension plan's investment in units of a regulation 5000(7) pooled fund trust constitutes foreign property to it, the relevant period for examining the foreign property content of the pooled fund trust is 1996.[32]

• The foreign property content of the pooled fund trust must not exceed the 20 percent limit at *any time* during the relevant period.[33] This is a more onerous test than that imposed on entities subject to part XI in that under part XI it is only the foreign property content at the end of any particular month that is relevant.

Taxation of a Regulation 5000(7) Pooled Fund Trust

A regulation 5000(7) pooled fund trust does not enjoy any exemption from taxes under part I or part XII.2. As a practical matter, however, a regulation 5000(7) pooled fund trust will not incur part I tax in a particular year so long as all of its income for that year (including net taxable capital gains) is paid or payable to its beneficiaries in that year. (This is subject to the comments above relating to alternative minimum tax.) A regulation 5000(7) pooled fund trust also will not incur part XII.2 tax in a year if it has no "designated beneficiaries" in that year. Provided that the only beneficiaries of the pooled fund trust from its inception are registered pension plans, it will have no designated beneficiaries and will not be subject to part XII.2 tax. If, however, the pooled fund trust were in turn to invest some of its funds in another trust (that is, in a fund-on-fund situation), part XII.2 tax could, as discussed above, be payable by the bottom fund.

Advantages and Disadvantages of a Regulation 5000(7) Pooled Fund Trust

Probably the most significant advantage to registered pension plans of investing through a regulation 5000(7) pooled fund trust is the potential it provides for increasing their foreign property room. The additional room is achieved by the registered pension plan's investing as to 20 percent

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[32] For a pooled fund trust that has not yet completed its first taxation year, the trust's taxation year that includes the end of the particular month in issue is the relevant period for that month.

[33] The only exception to this requirement is the situation where the relevant period is the trust's taxation year that includes the particular month (as discussed in footnote 32, supra). In this case, so long as the foreign property content of the pooled fund trust *at the end* of the relevant period (rather than *at all times during* the relevant period) does not exceed the 20 percent limit, an interest in the trust does not constitute foreign property: see regulation 5000(2).

directly in foreign property and as to the other 80 percent in a regulation 5000(7) pooled fund trust, which itself is invested up to 20 percent in foreign property. In theory, a registered pension plan could in this manner achieve 36 percent foreign property content (20% + 20% (80%)), although it is generally advisable to leave some margin for error. This is because of the uncertainties inherent in the definition of foreign property and also because foreign property content is calculated on the basis of cost amount, which, in an actively traded portfolio, will be changing regularly.

The main disadvantage of the regulation 5000(7) pooled fund trust relates to the investment restrictions imposed by the asset and income limitation tests described above and the need to carefully monitor compliance with these tests. Where the pension plans are making a one-time only investment in the trust (and distributions are not being reinvested in additional units of the trust), these restrictions may not be an overly serious concern. Provided that the trust qualifies in either the "first relevant year" or the "second relevant year" (as described above), it is irrelevant whether it qualifies at any other time. (However, the requirement that the trust restrict its foreign property content to 20 percent is an ongoing requirement.) If, on the other hand, the pension plans are investing in the pooled fund on a regular basis (as will be the case where multiple pension plans of a single employer are using the pooled fund vehicle in order to pool their funds for investment purposes or if trust distributions are being reinvested in additional trust units), the trust must satisfy the regulation 5000(7) requirements on an almost continuous basis commencing with the second relevant year.[34] Where a pooled fund trust goes offside (either because it fails to satisfy the requirements of regulation 5000(7) throughout the relevant periods or because it acquires foreign property in excess of the 20 percent limit), some or all of the pension plan's investment in the trust may constitute foreign property, resulting in an unexpected liability for part XI tax in the pension plan.

All is not necessarily lost where it is discovered that the pooled fund trust has gone offside. First of all, pursuant to subparagraph 206(2)(a)(iii), there is a 24-month grace period where the interest in the trust was not foreign property at the time it was acquired by the pension plan but subsequently became foreign property. As well, a section 259 election may be a useful tool for "damage control" in these circumstances. In very general terms, section 259 permits a trust that is a "qualified trust"[35] to

[34] There is a small degree of flexibility in this regard, given that it is sufficient for the trust to satisfy the regulation 5000(7) requirements during either the first relevant year or the second relevant year.

[35] The requirements for qualification as a "qualified trust" are as follows: the trust cannot be a registered investment or small business investment trust; each trustee must be either a trust company authorized under the laws of Canada or a province to carry on business in Canada as such or a trustee of a registered pension plan; all interests of the beneficiaries of the trust must be described by reference to units, all of which must be identical; the trust must not borrow money except for a term of 90 days or less; and the trust must not accept deposits.

make an election so that each of its investors is deemed, for purposes of, inter alia, the foreign property rules, not to hold an interest in the trust but instead to hold a proportionate interest in each property held by the trust; that is, effectively the trust is ignored or "looked through" and the characteristics of the underlying property are flowed through to the investor. The section 259 election is advantageous where the pension plan's interest in the trust would otherwise constitute foreign property to it, but only a portion of the trust's property is foreign property. The election can be made with retroactive effect for up to 15 months. The 15-month ceiling on the retroactive application of section 259 limits its usefulness. By the time it is discovered that a trust has gone offside, the 15-month period may have passed and it may be too late to take advantage of the election.

Finally, where it is discovered that the pooled fund trust has gone offside, it may be possible to elect to have the trust treated as a master trust under paragraph 149(1)(o.4). Paragraph 149(1)(o.4) master trust status as a fallback position is discussed in more detail below.

Paragraph 149(1)(o.4) Master Trust

Pursuant to regulation 5000(1.2), an interest in a paragraph 149(1)(o.4) master trust does not constitute foreign property to a registered pension plan so long as either (1) the pension plan does not own any foreign property or (2) the master trust does not own any foreign property. In other words, foreign property may be held either at the pension plan level or at the master trust level, but not both. Accordingly, the paragraph 149(1)(o.4) master trust does not offer the same opportunity as the regulation 5000(7) pooled fund trust for increasing foreign property exposure. The requirements for qualification as a paragraph 149(1)(o.4) master trust are discussed below, as well as the taxation of this type of trust and the advantages and disadvantages of its use.

Qualifying as a Paragraph 149(1)(o.4) Master Trust

A trust that meets the requirements of regulation 5001 and makes an election pursuant to paragraph 149(1)(o.4) is a paragraph 149(1)(o.4) master trust. A trust qualifies under regulation 5001 if, throughout its existence,

1) it was resident in Canada;

2) its only undertaking was the investing of its funds;

3) it never borrowed money (except for terms of 90 days or less);

4) it never accepted deposits; and

5) each of the beneficiaries of the trust was a registered pension plan or DPSP.

The requirements in 1, 3, 4, and 5 are relatively straightforward and create little, if any, potential for dispute with Revenue Canada. However, the requirement in 2, that the master trust's only undertaking be the investing of its funds, merits comment. This language is not unique to master trusts. It is also used, for example, in the definitions of "mutual fund corporation" and "mutual fund trust."[36] Dictionary definitions of "invest" and "investment" suggest that this requirement is potentially quite restrictive. For example, *Black's Law Dictionary*, sixth edition provides the following definitions:

> Investment. An expenditure to acquire property or other assets in order to produce revenue; the asset so acquired. The placing of capital or laying out of money in a way intended to secure income or profit from its employment. . . . To purchase securities of a more or less permanent nature, or to place money or property in business ventures or real estate, or otherwise lay it out, so that it may produce revenue or gain (or both) in the future.
>
> Invest. See investment.

Given these definitions, an argument could be made that the trust must confine itself to acquiring property on capital account and avoid activities that are on income account.

Fortunately, Revenue Canada appears to interpret the phrase "investing of its funds" more generously. The mere fact that some of the transactions engaged in are of an income rather than a capital nature does not necessarily result in a breach of the requirement. For example, in a recent technical interpretation,[37] Revenue Canada expressed the view that the writing of put options and covered call options by a trust would be considered to be the investing of its funds for purposes of determining the trust's qualification as a mutual fund trust (apparently on the basis that such activities are ancillary to investing). In the same technical interpretation, Revenue Canada took the position that the lending or borrowing of qualified securities pursuant to a securities lending arrangement (as defined in subsection 260(1)) also constitutes the investing of funds. In another technical interpretation,[38] Revenue Canada took the position that transactions with respect to commodity futures contracts would be considered to be on income account but nevertheless would constitute investing for purposes of determining whether the trust qualified as a mutual fund trust.

It is worth reiterating that the requirements of regulation 5001 must be satisfied throughout the trust's existence in order for the trust to be eligible for the election under paragraph 149(1)(o.4). The election need not necessarily be made in the trust's income tax return for its first year, although until the election is made the trust will not qualify as a paragraph 149(1)(o.4) master trust.

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[36] See subsections 131(8) and 132(6).

[37] Technical interpretation issued by the Income Tax Rulings and Interpretations Directorate, in Revenue Canada Views [database online], document no. 9606285, April 18, 1996.

[38] Technical interpretation issued by the Rulings Directorate, in Revenue Canada Views [database online], document no. 9337012, March 31, 1994. See also the following other documents available in the Revenue Canada Views database: document no. May 1991-229, May 1991; document no. December 1991-94, December 1991; and document no. 9134595, March 9, 1992.

As suggested earlier, in some circumstances, paragraph 149(1)(o.4) master trust status may provide a useful fallback position. For example, where in a year a trust that was intended to qualify as a regulation 5000(7) pooled fund trust breaches one of the requirements therefor, consideration could be given to making a paragraph 149(1)(o.4) election in the trust's income tax return for the year. Given the relatively innocuous nature of the conditions in regulation 5001, the trust may well have satisfied them throughout its existence. Electing paragraph 149(1)(o.4) trust status would, however, be advantageous only if foreign property was held at either the pension plan level or the master trust level, but not both.

Taxation of a Paragraph 149(1)(o.4) Master Trust

A paragraph 149(1)(o.4) master trust is exempt from both part I tax and part XII.2 tax. However, it is subject to the foreign property rules in part XI of the Act. Accordingly, if its foreign property holdings exceed the 20 percent limit (plus three times any small business investment amount), the trust itself is liable for the penalty tax on excess foreign property holdings. As well, the trust is subject to section 206.1, which imposes a penalty tax in certain circumstances where the trust enters into an agreement to acquire shares of a corporation (otherwise than from the corporation) at a price that may differ from their fair market value at the time they may be acquired.

Advantages and Disadvantages of Using a Paragraph 149(1)(o.4) Master Trust

As discussed above, qualification of a trust as a paragraph 149(1)(o.4) master trust is relatively simple. In contrast to the case of the regulation 5000(7) pooled fund trust, no difficult definitional issues arise, and it is not necessary to carefully monitor the investments held by the trust (other than its foreign property content). On the other hand, the paragraph 149(1)(o.4) master trust does not provide any opportunity for obtaining additional foreign property room. This is because, in order for units of the master trust not to constitute foreign property to a pension plan investor, foreign property may be held either at the pension plan level or at the master trust level, but not both. This requirement that foreign property be held at one level only can create a trap for the unwary. Where the master trust owns foreign property, if the pension plan inadvertently acquires even a very small amount of foreign property (or is deemed to hold foreign property as a result of a section 259 election by another trust in which it has an interest), the pension plan's entire investment in the master trust constitutes foreign property to the pension plan. This absence of any margin for error is a concern, particularly given the uncertainties inherent in the definition of foreign property and accordingly the frequent difficulty of determining whether a particular property is caught within the definition. Where this happens, a section 259 election (discussed above) should be considered. Pursuant to subsection 206(2.1), a master trust that elects under section 259 is exempt from tax on any excess foreign property.

Registered Investment

An interest in a trust that is a registered investment is excluded from the definition of foreign property. Registered investments are provided for in part X.2 of the Act. Certain trusts and corporations can be registered as registered investments in respect of RRSPs, RRIFs, and/or DPSPs. An investment cannot be registered in respect of a registered pension plan. However, if a trust is registered in respect of, for example, RRSPs, it is excluded from the definition of foreign property for all purposes. Therefore, while the result appears somewhat anomalous, a trust that is to be owned exclusively by registered pension plans could be registered as a registered investment in respect of RRSPs and an interest therein would not constitute foreign property to the registered pension plan investors. The requirements for qualification as a registered investment are discussed below, as well as the taxation of a registered investment and its advantages and disadvantages.

Qualifying as a Registered Investment

There are a number of bases on which a trust or corporation may apply to become a registered investment. In the context of a pooled fund of a private, closely held nature owned entirely by pension plans, the most attractive basis on which to seek registered investment status is that of a quasi mutual fund trust as described in paragraph 204.4(2)(d).[39]

A paragraph 204.4(2)(d) quasi mutual fund trust is a trust that satisfies all of the requirements for a mutual fund trust (as defined in subsection 132(6)),[40] except the requirement in regulation 4801(a) that a class of its units be qualified for distribution to the public and the requirement in regulation 4801(b) relating to the number of its unit holders. A quasi

[39] The other bases on which registered investment status may be obtained are a pooled fund (paragraph 204.4(2)(a)), a quasi pooled fund (paragraph 204.4(2)(b)), a mutual fund trust (paragraph 204.4(2)(c)), a mutual fund corporation or investment corporation (paragraph 204.4(2)(e)), and a quasi mutual fund corporation or quasi investment corporation (paragraph 204.4(2)(f)). The ownership requirements and the investment restrictions for a pooled fund generally make it an inappropriate vehicle in the present context. The investment restrictions associated with a quasi pooled fund are more onerous than those that apply to a quasi mutual fund trust, rendering it a less attractive approach. The mutual fund trust is not feasible because of the minimum number of unit holders required. Finally, the corporate vehicles are unattractive because they do not provide as complete flowthrough treatment as may be obtained with a trust, and hence some tax is generally payable at the corporate level.

[40] Under subsection 132(6), a trust is a "mutual fund trust" if it meets the following conditions: (1) it is a "unit trust" resident in Canada; (2) its only undertaking is investing its funds and certain permitted real estate activities; and (3) it complies with the conditions prescribed by regulation 4801 relating to the public distribution of its units and the number of its unit holders. "Unit trust" is defined in subsection 108(2). A unit trust is an inter vivos trust where the interest of each beneficiary is described by reference to units. The trust can be either "open end" or "closed end." An open end trust is one in which units representing at least 95 percent of the value of the trust are redeemable at the demand of the holder; a closed end trust must satisfy certain investment and other restrictions.

mutual fund trust that is a registered investment must hold only prescribed investments for the type of plan for which it is registered; that is, if it is registered for, say, RRSPs, it must hold only qualified investments for RRSPs. While a trust's failure to hold only prescribed investments will not result in revocation of its registered investment status, the trust will be liable for penalty taxes (discussed below).

Taxation of a Quasi Mutual Fund Trust That Is a Registered Investment

Registered investment status does not exempt a quasi mutual fund trust from tax under part I or part XII.2. Accordingly, as in the case of the regulation 5000(7) pooled fund trust, it is important to ensure that all of the trust's income in each year is paid or payable to its beneficiaries in that year, and there is the potential for alternative minimum tax liability in limited circumstances. The trust will not be subject to any part XII.2 tax if the only beneficiaries since its inception are registered pension plans. However, the comments above relating to part XII.2 tax in the context of fund-on-fund situations (that is, if the quasi mutual fund trust were in turn to invest in another trust) apply equally here.

Registered investments are subject to the foreign property rules in part XI of the Act. If at any month-end the trust's foreign property holdings exceed the 20 percent limit, the trust itself will be liable for the penalty tax on excess foreign property holdings. The ability of registered pension plans (and various other entities subject to part XI) to increase their foreign property room by investing in small business properties does not apply to registered investments. As well, the trust is subject to section 206.1, which, as discussed above, imposes a penalty tax in certain circumstances where an agreement is entered into to acquire shares at a price that may differ from fair market value.

Finally, a quasi mutual fund trust that is a registered investment may be subject to penalty tax under subsection 204.6(1). If at the end of any month the trust holds any investment that is not a qualified investment for the type of plan for which it is registered, it is liable for a penalty tax equal to 1 percent of the fair market value of the investment at the time it was acquired.

Advantages and Disadvantages of a Quasi Mutual Fund Trust Registered as a Registered Investment

As in the case of the regulation 5000(7) pooled fund trust, the registered investment structure offers the opportunity to obtain additional foreign property room. A pension plan can invest as to 20 percent directly in foreign property and as to the other 80 percent in a registered investment that itself is invested up to 20 percent in foreign property, thereby obtaining up to 36 percent foreign property exposure. Another advantage of the registered investment approach is that the pension plan investors can be certain that their units will not inadvertently become foreign property. So long as the trust continues to be a registered investment,[41] units of the trust will not be foreign property, even though the trust's foreign property holdings may exceed the 20 percent limit. As a registered investment, the trust pays the part XI penalty tax on any excess foreign property content. While this tax will be of concern to the pension plan investors in that it is indirectly borne by them, this is preferable to having their entire investment in the trust constitute foreign property, as can be the case with the regulation 5000(7) pooled fund trust approach.

The main drawback of a quasi mutual fund trust that is a registered investment is that, in order to avoid penalty taxes, the trust must restrict itself to prescribed investments for the type of plan for which it is registered—that is, RRSP-type qualified investments. This restriction will frequently render the registered investment structure unacceptable. Nevertheless, depending on the investment objectives of the pooled fund, there may be circumstances in which the restrictions imposed by the qualified investment rules for RRSPs are less troublesome than the investment restrictions for a regulation 5000(7) pooled fund trust. For example, the types of debt instruments that constitute a qualified investment for an RRSP are broader than the types of debt that may be held by a regulation 5000(7) pooled fund trust. As discussed above, debt that may be held by a regulation 5000(7) pooled fund trust is limited to "bonds," "mortgages," and "marketable securities," while qualified investments for RRSPs include "bonds," "debentures," "notes," or "similar obligations" of publicly traded corporations and of Canadian and certain foreign governments. As well, the cost amount to a regulation 5000(7) pooled fund trust of securities of any one corporation or debtor (other than government securities) cannot exceed 10 percent of the cost amount of all of its property, while a quasi mutual fund trust that is a registered investment is subject to no such restrictions and could, at least in theory, restrict its investments to securities of a single issuer. For an equity-based fund, on the other hand, compliance with the investment restrictions for a regulation 5000(7) pooled fund trust will generally be preferable to compliance with the qualified investment rules for RRSPs. While a regulation 5000(7) pooled fund trust can invest in any shares, the circumstances in which shares of a non-public corporation constitute a qualified investment for RRSPs are very limited. As well, 20 percent of the cost amount of the assets of a regulation 5000(7) pooled fund trust may be attributable to assets of any type (although the 95 percent of income test may effectively reduce a fund's flexibility in this regard). There is no such "basket" provision for RRSPs.

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[41] The minister of national revenue may revoke the registration of a registered investment where it no longer complies with the conditions necessary for registration (other than the condition that it restrict its investments to qualified investments). The minister must, however, provide notice of his intention to revoke registration, and if the registered investment remedies the defect within three months, the minister may declare the notice a nullity. See subsections 204.4(3) and (5).

Regulation 5000(1)(c) Quasi Mutual Fund Trust

The use of a regulation 5000(1)(c) quasi mutual fund trust in the context of pension plan investment through a private pooled fund vehicle is a somewhat unconventional approach but one which, in the author's view, can be advantageous and merits a brief comment.

Pursuant to regulation 5000(1), an interest in a regulation 5000(1)(c) quasi mutual fund trust does not constitute foreign property to a registered pension plan provided that the cost amount to the trust of its foreign property does not exceed 20 percent of the cost amount to it of all of its property. A quasi mutual fund trust under regulation 5000(1)(c) is identical to a quasi mutual fund trust that is eligible to be registered as a registered investment under paragraph 204.4(2)(d), except in one critical respect. As discussed above, a paragraph 204.4(2)(d) quasi mutual fund trust is a trust that satisfies all of the requirements for a mutual fund trust except the requirement in regulation 4801(a) that a class of its units be qualified for distribution to the public and the requirement in regulation 4801(b) relating to the number of its unit holders. A regulation 5000(1)(c) quasi mutual fund trust, on the other hand, is a trust that satisfies the requirements for a mutual fund trust, excluding the requirement in regulation 4801(b) but including the requirement in regulation 4801(a). In other words, a paragraph 204.4(2)(d) quasi mutual fund trust need not comply with either regulation 4801(a) or regulation 4801(b), while a regulation 5000(1)(c) quasi mutual fund trust need not comply with regulation 4801(b) but must have a class of its units qualified for distribution to the public.

There is a significant advantage in the trust's qualifying as a regulation 5000(1)(c) quasi mutual fund trust rather than as a quasi mutual fund trust that is a registered investment under paragraph 204.4(2)(d). As indicated above, in order to avoid penalty taxes, a paragraph 204.4(2)(d) registered investment must restrict its investments to RRSP-type qualified investments. No such investment restrictions apply to a regulation 5000(1)(c) quasi mutual fund trust. In addition, a regulation 5000(1)(c) quasi mutual fund trust is not subject to the investment restrictions applicable to regulation 5000(7) pooled fund trusts (except that, like the regulation 5000(7) pooled fund trust, it must restrict its foreign property content to the 20 percent limit in order for its units not to constitute foreign property). Like the registered investment approach and the regulation 5000(7) pooled fund trust approach, the regulation 5000(1)(c) quasi mutual fund trust offers the opportunity to obtain additional foreign property room. A pension plan can invest as to 20 percent directly in foreign property and as to the other 80 percent in a regulation 5000(1)(c) quasi mutual fund trust that is itself invested up to 20 percent in foreign property.

Given the advantages of qualification as a regulation 5000(1)(c) quasi mutual fund trust, it is worth considering whether it is feasible for the pooled fund vehicle to satisfy regulation 4801(a)—that is, to qualify a class of its units for distribution to the public. Pursuant to regulation 4803(2)(a) and Revenue Canada administrative practice, delivery of an offering memorandum in circumstances required by securities legislation to, for example, the Ontario Securities Commission and the lawful distribution of trust units in accordance therewith would generally be sufficient to satisfy regulation 4801(a).[42] Although this approach seems somewhat anomalous in the context of a pooled fund vehicle of a private, closely held nature, there does not appear to be anything to prevent the fund from going this route. Of course, the delivery of an offering memorandum and the associated filing fees add a layer of complexity and expense which would have to be weighed against the tax advantages of the fund's qualifying as a regulation 5000(1)(c) quasi mutual fund trust.

CONCLUSION

Investment by a registered pension plan through a private pooled fund vehicle raises complex income tax issues. An understanding of these issues is critical in determining the structure of the pooled fund vehicle. If the applicable rules are not carefully considered and adhered to, an unexpected tax liability may arise which may far outweigh the non-tax benefits of a pooled fund structure. The rules, however, can also be viewed as a source of opportunity, in that certain pooled fund structures enable a pension plan to achieve greater foreign property exposure than would be possible were the plan to hold the underlying investments directly.

[42] Pursuant to regulation 4803(2)(a), a class of units of a trust is qualified for distribution to the public if a "prospectus, registration statement or similar document" has been filed with the appropriate regulatory authority pursuant to and in accordance with the law of Canada or a province, and there has been a lawful distribution to the public of units of that class in accordance with that document. Revenue Canada takes the position that an offering memorandum is a "similar document" for purposes of regulation 4803(2)(a). See, for example, the technical interpretation issued by the Rulings Directorate, Manufacturing Industries, Partnerships and Trusts Division, in Revenue Canada Views [database online], document no. 9409416, September 29, 1994. In Ontario, where the trust is relying on the minimum purchase exemption and delivers an offering memorandum to prospective purchasers, the offering memorandum is required to be delivered to the Ontario Securities Commission.