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# Use of “private” mutual fund trusts for employee’ investments through an RRSP

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An increasing number of employers are looking at the possibility of creating investment vehicles to allow their employees to make investments in the employer corporation or a portfolio managed by the employer that will qualify for inclusion in, *inter alia*, registered retirement savings plans (RRSP), registered retirement income funds (RRIF), registered education savings plans (RESP) and tax-free savings accounts (TFSA) (collectively referred to hereinafter as the “**Registered Plans**”).

The following discusses the possible use of an entity that qualifies as a “mutual fund trust” (“**MFT**”) under the *Income Tax Act* (Canada) (“**ITA**”) for that purpose.

There are multiple tax benefits that can be derived from MFT status, but the main advantage is that units of an MFT qualify for inclusion in, *inter alia*, the Registered Plans. This is why this structure is often used by managers of hedge funds or pooled funds that are raising capital from individuals. These conditions are summarized below.

## 1. Conditions for Mutual Fund Trust qualification

**a) The trust must be resident in Canada**

As a general rule, as long as the trustee(s) are resident in Canada and carry out their duties in Canada this should not be an issue.

**b) The trust must be a unit trust**

A trust can qualify as a unit trust in one of two alternate ways.

> First, not more than 10% of the trust’s property may be in bonds, securities or shares of one corporation and at least 80% of the trust’s property has to be in various securities, real property or royalties (closed-end unit trust). Second, interests of each beneficiary must be described by reference to units and the issued units of the trust must have conditions requiring the trust to redeem the units at the demand of the holder at prices determined and payable in accordance with the conditions. The fair market value of such units must not be less than 95% of the fair

market value of all of the issued units of the trust (open-end unit trust).

**c) The trust's only undertaking is the investing of its funds in property**

The rules for an MFT and for a unit trust restrict the trust to permitted activities. As a general rule, the trust must restrict its undertaking to investing of funds in property. The trust cannot carry on a business. A trust may own real property and is permitted to acquire, hold, maintain, improve, lease or manage real property as long as the real property is "capital property" of the MFT.

**d) The trust must comply with prescribed conditions relating to the number of its unitholders, dispersal of ownership of units and public trading**

Generally, the units must be qualified for distribution to the public or there must have been a lawful distribution of the units to the public in a province. There should be no fewer than 150 beneficiaries of the trust, each of whom hold not less than one block of units and units having an aggregate fair market value of not less than $500. A block of units normally means 100 units if a unit has a market value of less than $25, 25 if the value is between $25 and $100 and 10 units where a unit is $100 or more.

**e) It must be reasonable to conclude that the trust was not established primarily for the benefit of non-resident persons**

An additional qualification for MFT status is that it must not be reasonable having regard to all the circumstances that the trust is considered to be established primarily for the benefit of non-resident persons. It is generally accepted that the "primarily" requirement means more than 50% and the trust deed should contain provisions which allow the expulsion of non-residents if the threshold would otherwise be breached.

## 2. Mutual Fund Trust as investment vehicle in a private corporation

The characteristics of an MFT make it an attractive vehicle to facilitate employee participation in a private corporation or in a portfolio to the extent that the number of employees interested in becoming shareholders of the employer corporation meet the minimum requirement of 150 unitholders. Since the units of an MFT qualify for inclusion in the Registered Plans, the employee may decide to invest in the private employer corporation or the portfolio through the Registered Plan. A direct equity investment in the private employer corporation or in a portfolio may not qualify for inclusion in the Registered Plans since the Income Tax Regulations (Canada) provide for strict conditions for the qualification of such an investment as a "qualified investment". The interposition of an MFT whose units are "qualified investments" between the Registered Plans and the employer corporation or the portfolio managed by the employer would provide more comfort in that regard.

An interesting question is whether each Registered Plan would count as a single unitholder for purposes of the minimum requirement of 150 unitholders described above. Since the ITA treats each Registered Plan as a trust under the ITA (and therefore as a distinct person from the beneficiary or annuitant), an argument could probably be made that each Registered Plan should count as a distinct unitholder for purposes of the 150 unitholders requirement. This position seems to be consistent with statements by the Canada Revenue Agency ("**CRA**") to the effect that all qualified investments of a plan trust must be owned by the trustee of the plan trust and not by the annuitant, beneficiary or subscriber under the plan trust. In the case of a share or other security, registration of the security in the name of the trustee of the plan trust is proof of the trustee's ownership.[1]

Moreover, the CRA has taken the position in the past that where a group RRSP is established and it “holds” the units of an MFT, the number of beneficiaries of the MFT will at least be equal to the number of annuitants of the group RRSP. Each participant in a group RRSP should therefore count as one unitholder.

## 3. Prohibited investments rules

In structuring the participation of employees in the private employer corporation or the portfolio managed by the employer through an MFT, the rules governing “prohibited investments” under the ITA should be considered. Registered Plans holding prohibited investments are subject to severe penalties under the ITA.

Units of an MFT will generally be “prohibited investments” for a Registered Plan to the extent that the unitholder’s interest in an MFT, either alone or together with non-arm’s length persons, is 10% or more.

As a result, while each of the Registered Plans of a single unitholder could possibly count as distinct unitholders for purposes of the 150 unitholders requirement discussed above, the “prohibited investments” rules would impose a very strict set of limitations in terms of the threshold of ownership interest in units.

## 4. Securities Registration Requirements

The employer managing the MFT must also ensure that it meets all of the registration requirements imposed by Canadian securities regulatory authorities. If the MFT will be used to invest in the employer corporation, there are likely to be circumstances allowing the employer not to have to register as an investment fund manager or adviser. However, if the employer instead offers a different portfolio for the employees to invest in (for example, a portfolio selected by it in connection with the management of the portfolio of the pension plans that are administered by it), it will likely have to register at least as an adviser and probably also as investment fund manager.

## Conclusion

While the structuring of employees’ equity investments through the use of an MTF could be advantageous, various incidental rules must be considered in order to ensure that the units of such a “private” MFT can qualify for inclusion in a Registered Plan.

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1. Income Tax Folio S3-F10-C1, Qualified Investments-RRSPs, RESPs, RRIFs, RDSPs and TFSA.