Goodmans LLP Update

Income Tax

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Government Passes Stricter Rules for RRSPS

Background

As part of the 2011 federal budget, the Minister of Finance (Canada) modified the rules applicable to the taxation of registered retirement savings plans ("**RRSPs**") (the new rules also apply to registered retirement income funds). Bill C-13 received Royal Assent on December 16, 2011, and these amendments generally are effective as of March 23, 2011.

There are three fundamental income tax considerations applicable to an RRSP: (i) contributions to an RRSP are tax deductible; (ii) earnings (investment income and capital gains) within an RRSP are not subject to tax; and (iii) distributions from an RRSP to the holder are taxed as ordinary income. Over the years, RRSPs have been used by the Canadian Government to encourage the accumulation of savings for retirement and, in general, the list of qualified investments has expanded with the market to capture many common types of investment products. However, planning strategies have been developed to push the boundaries of the RRSP rules. These include:

- transactions designed to increase the amount of capital within an RRSP (for example, a "swap transaction" that uses small market changes in pricing to shift value to an RRSP);
- transactions that effectively permit the earning of business or professional income in an RRSP (for example, through the use of a "private" mutual fund trust); and
- structures that effectively provide a holder with the personal use or benefit of RRSP funds without immediate taxation (a "strip transaction").

Each of these strategies has been addressed in the new rules through the "advantage" concept. In addition, the rules now also impose a 10% ownership limit on most RRSP investments.

The New RRSP Rules

Broadly speaking, the new rules impose a significant penalty tax on "prohibited investments" and "advantages", both concepts borrowed from the recently introduced TFSA rules. The new rules also change the treatment of "non-qualified investments". The effect of these new rules can be onerous and detrimental in many circumstances. In particular, existing investments in an RRSP that complied with the previous law may now be prohibited and may result in significant adverse tax consequences to the holder. Going forward, considerable scrutiny must be placed on investments to confirm that they comply with the new rules.

Prohibited Investments

A prohibited investment generally includes a debt of the holder, and investments in entities in which the holder, and non-arm's length persons, have a significant interest (generally 10% or more of any class of securities of the particular entity or any related entity), or with which the holder does not deal at arm's length. In addition, certain private company investments (which are qualified investments) may now become prohibited investments where the private company ceases to be a "specified small business corporation" while it is held by the RRSP.

There are a number of concerns with the concept of prohibited investment. In particular, many existing qualified investments are not subject to a 10% ownership limit (for example, shares of public companies) such that a qualified investment may now be a prohibited investment. Second, the 10% test is applied very broadly, and the non-arm's length concept may extend to a large (and sometimes uncertain) group of investors.

There are generally two consequences of holding a prohibited investment in an RRSP, which will apply where the RRSP acquires a prohibited investment or an existing investment becomes a prohibited investment.

First, the holder will be liable for a penalty tax equal to ***50%*** of the fair market value of the investment at the time the RRSP acquires the investment or at the time the investment becomes a prohibited investment (although investments which were prohibited investments held by the RRSP on March 22, 2011 are generally exempted from this tax). This tax generally will be refunded if the prohibited investment is disposed of by the end of the following year (or later if the Minister agrees), provided that the holder was not reasonably aware that the investment was (or would become) prohibited when it was acquired. Second, income (including capital gains) reasonably attributable to the prohibited investment will be subject to tax as an "advantage".

Advantage

The rules also impose a tax on the holder equal to ***100%*** of the fair market value of an advantage. The tax may be waived at the Minister's discretion, provided that an equivalent amount is distributed from the RRSP to the holder. The rules provide for limited grandfathering in respect of prohibited investments held on March 23, 2011, as described below.

An advantage is broadly defined to include all income, including capital gains, reasonably attributable to a prohibited investment. As a result, where an RRSP holds a prohibited investment, in addition to the ***50%*** acquisition tax discussed above, all income and gains attributable to that investment will be subject to a ***100%*** tax. An advantage also includes certain benefits:

- from a transaction that would not have occurred in an open market, where the transaction was undertaken to benefit from the tax-free status of an RRSP;
- related to non-qualified investments, the income from which has not been removed from the RRSP within 90 days of a request by the Minister that the income be removed; and
- from RRSP "strip transactions" and "swap transactions".

Non-Qualified Investments

The new rules also change the manner in which non-qualified investments are treated. Under the old rules, the acquisition of a non-qualified investment resulted in an income inclusion to the holder, and where a qualified investment became a non-qualified investment, the trust was subject to a monthly 1% tax. In addition, any income realized in respect of the non-qualified investment was subject to tax to the trust. The new rules eliminate the income inclusion on acquisition and the 1% monthly tax, and instead impose a ***50%*** penalty tax on acquisition in the same manner as with prohibited investments. The penalty tax may also be refunded in the same circumstances as with prohibited investments.

Going Forward

The new rules raise a number of fundamental issues for RRSPs that should be considered. Obviously, the prospect of a ***50%*** acquisition tax (which is only refunded if the investment is removed from the RRSP or sold), and a ***100%*** tax on income and capital gains, warrants significant attention.

If an RRSP currently holds a private investment, or a public investment where the holder and related persons have a significant stake in the entity, the new rules should be reviewed to determine if the investment is now a prohibited investment. Limited grandfathering from the advantage tax is available for prohibited investments held on March 23, 2011 if the holder makes an election before ***July, 2012.*** If this election is made, income and gains from the investment must be paid out of the RRSP to the holder each year (thereby subjecting the income to tax in the holder's hands). In addition, the grandfathered investment must be removed from the RRSP before 2022; this could be problematic because a withdrawal of an investment from an RRSP could result in a significant tax liability to the holder and liquidity issues could arise where significant private investments are held.

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For new investments, taxpayers should pay particular attention to the 10% ownership limit; it is broadly drafted and could apply where the holder does not economically own 10% or more of the underlying entity or where the 10% limit is exceeded without any action by the holder. For private investments, the new rules no longer "freeze" the 10% ownership limit or the "small business corporation" status at the time of acquisition. As a result, continuous monitoring of these conditions is required, and RRSP investors should consider seeking covenants that the applicable conditions will be maintained in good standing at all material times.

In addition, the new "open market" requirement in the advantage rules is subject to some uncertainty. Greater experience with the application of these rules will be required before significant comfort may be obtained in many circumstances, particularly with respect to private investments.

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