Department of Finance Canada | Ministère des Finances Canada

Ottawa, Canada
K1A 0G5

2012FIN370816

Mr. Darcy Moch & Ms. Penny Woolford
Co-Chairs
The Joint Committee on Taxation of
The Canadian Bar Association
500-585 Carling Avenue
Ottawa ON K1S 5S8

and

The Canadian Institute of Chartered Accountants
277 Wellington St. W.
Toronto ON M5V 3H2

Dear Mr. Moch and Ms. Woolford:

I am writing to follow up on our discussions with members of the Joint Committee regarding the Joint Committee's submission dated October 28, 2011 on the registered retirement savings plan and registered retirement income fund (RRSP) measures included in Budget 2011 which have now been implemented as part of Bill C-13.

Preliminary Matters

Your submission raises a number of issues, which range from broad policy considerations to very technical matters. We would, at the outset, like to thank the members of the Joint Committee for their comments on these measures, which clearly required significant time and thought.

As we noted during our most recent conference call, and as discussed in more detail below, we agree with some of the concerns raised and will be recommending to the Minister of Finance that technical amendments be introduced to modify the impact of some of the rules, particularly with regard to the prohibited investment rules. We will also recommend that the effective date of these technical amendments coincide with the effective date of the Budget 2011 measures.

General Comments

The contribution and benefit limits for registered pension plans (RPPs) and RRSPs are designed to permit most individuals to save enough, over a 35-year career, to obtain a pension equal to 70 per cent of pre-retirement earnings, an amount generally considered sufficient to allow individuals to maintain their living standards in retirement. Individuals are permitted to contribute 18 per cent of earnings annually to an RRSP or defined contribution RPP, up to a specified dollar limit ($22,970 and $23,820 respectively for 2012, equating to 18 per cent of about $128,000 per year). Defined benefit RPPs are permitted to provide pension benefits of 2 per cent of earnings per year of service, up to a specified dollar limit ($2,647 for 2012). The RPP and RRSP dollar limits are indexed to average wage growth. The RRSP and defined contribution RPP limits are designed to provide savings opportunities comparable to those available under the limits for defined benefit RPPs, based on several long-term economic assumptions. The RPP and RRSP limits are also integrated, in order to provide comparable retirement savings opportunities whether an individual saves in an RPP, an RRSP or both.

In short, the various tax-deferred retirement savings plans contemplated by the *Income Tax Act* (the Act) are intended to enable individuals, who may be members or annuitants under different plans, to achieve roughly similar levels of savings. Although the actual savings achieved will depend on the timing and level of contributions and the returns achieved compared to the assumptions upon which the retirement savings system is based, the main objective of the tax rules that govern RPP and RRSP savings is to facilitate retirement savings up to the limits described above.

The qualified investment rules have for many years contained parameters intended to prevent taxpayers from using RRSPs to shelter large amounts of investment or business income from tax, beyond the scope of these basic system parameters. For example, the pre-existing RRSP qualified investment rules contained explicit provisions directed at preventing the earning of income from employment or services inside a registered plan (regulations 4900(8) and (13) as they read prior to Bill C-13); and small business investments were subject to a general 10 per cent test similar to the prohibited investment rules, subject to what were intended to operate as minor exceptions, e.g. for lower value investments ($25,000).

In addition to addressing RRSP strip transactions, the Budget 2011 measures were fundamentally intended to return the scope of RRSP savings to these intended parameters. Having said that, we acknowledge that some taxpayers face challenges responding to the new rules, creating a need for reasonable transitional rules, as well as some guidance with regard to the broad waiver powers provided to the Minister of National Revenue in relation to these rules.

On this latter point, for more information regarding the administrative positions and procedures of the Canada Revenue Agency (CRA) in relation to the new rules, please refer to the Budget 2011 RRSPs questions and answers documents at www.cra-arc.gc.ca/tx/rgstrd/bdgt2011-eng.html and to CRA Rulings positions 2011-0418161E5 and 2011-0430141E5 (both dated February 3, 2012), which provide information on the rules and how to apply for a waiver of Part XI.01 taxes, including a (non-exhaustive) series of examples of situations in respect of which the CRA is favourably disposed to considering a waiver of taxes payable. These examples

in particular respond to a number of common questions and concerns and we believe provide important administrative guidance to taxpayers in respect of the new rules.

We note that the CRA has advised us that the restriction in subsection 207.06(3), which requires an amount equal to the "advantage" to be distributed from the registered plan before the advantage tax is waived, could unduly limit the scope for exercising the waiver powers in Part XI.01. We agree and will recommend that subsection 207.06(3) be repealed and replaced by an additional paragraph in subsection 207.06(2) that allows the full or partial removal of the advantage amount from a registered plan to be considered as a factor in determining whether some or all of the tax should be waived.

The balance of this letter addresses areas of your submission where we agree that technical amendments are warranted.

Grandfathering

You have requested several changes to the transitional rules for these measures, including complete grandfathering for pre-March 23, 2011 investments. The idea of complete grandfathering – that is, allowing taxpayers with pre-March 23, 2011 investments to be completely exempt from the new rules – raises serious fairness concerns. It would seem inappropriate to allow taxpayers to continue to enjoy indefinite tax-deferred savings benefits well beyond the limits contemplated by the tax system.

The improvements to the transitional rules for these measures reflect to a large extent comments made by members of the tax community and taxpayers in general, and provide a reasonable adjustment period for taxpayers, while ensuring that the basic policy intent of the RRSP system applies consistently going forward. Having said this, given that the transitional rules now require the Part I recognition of income and gains on prohibited investments, your suggestion that the current ten-year period in the transitional rules should be made indefinite has been considered and will be proposed. Consequently, it is intended that legislative amendments be put before Parliament to remove the termination date for transitional prohibited investment benefits.

Breadth of "significant interest"; use of arm's length vs. related; and the scope of subparagraph (*b*)(ii) of the definition "prohibited investment"

You raise a number of issues relating to circumstances where the legislation causes an investment to be a "prohibited investment" in circumstances where the actual registered plan investment is in the nature of a portfolio investment. We note that the arm's length test is used throughout the Act, but recognize that it is not as bright-line a test as "related" and that, while many taxpayers who currently hold prohibited investments appear to be part of a group with very close ties to the investment entity, it is possible to hold a portfolio position that, unknown to the taxpayer, is in fact a prohibited investment for the taxpayer's RRSP due to the combination of family holdings and/or non-arm's length relationships. We agree that the scope of the existing definition "prohibited investment" may be too broad in certain cases and could apply in circumstances where a particular individual's registered plan holds a comparatively small

investment in, for example, an investment fund controlled by their employer or by the employer of a family member.

Consequently we will recommend that subparagraph (*b*)(ii) of the definition "prohibited investment" in subsection 207.01 of the Act be amended to eliminate the words "or with a person or partnership described in subparagraph (i)". This change will generally have the effect of preventing an investment from being considered a "prohibited investment" in circumstances where the RRSP annuitant both lacks a "significant interest" in the corporation, partnership or trust in question and deals at arm's length with the corporation, trust, or partnership. (Under the existing definition, even if both those conditions are satisfied, a small portfolio investment could still be prohibited for an individual if the corporation, trust or partnership did not deal at arm's length with another corporation, trust or partnership, and the individual had a "significant interest" (which could in reality represent holdings by a family member) only in the latter.).

We note more generally the potential for an individual's registered plan to hold an investment that is technically a "prohibited investment" in a variety of circumstances where their direct investment through their registered plan is small in terms of value, relative to the capitalization of the entity, and is moreover substantially the same as the investment of numerous other arm's length parties in the same entity. In policy terms, the prohibited investment rules are intended to prevent the acquisition by an individual's registered plan of closely-held investments (in relation to the individual), or investments that carry a significant risk of being designed with a view to streaming disproportionate returns into a registered plan (effectively circumventing contribution limits) or that facilitate an intentional de-valuation of the investment (in order to avoid a later income inclusion).

In order to better target the prohibited investment rules, we will therefore recommend that income tax amendments be introduced to exclude from "prohibited investment" status a registered plan investment if all of the following are satisfied:

1. persons who deal at arm's length with the controlling individual of the registered plan hold at least
    a. 90% of the "equity value" (as defined in subsection 122.1(1) of the Act);
    b. 90% of the total of the "equity value" plus the outstanding debt of the organization; and
    c. 90% of the total votes associated with the "equity" (as defined in subsection 122.1(1) of the Act);

2. one or more persons who deal at arm's length with the controlling individual own equity that has terms and conditions that are substantially similar to the terms and conditions of the investment that is held by the registered plan, and if that equity owned by those arm's length persons was acquired by a particular individual, that individual would be a specified shareholder or a specified unitholder of the organization determined, if the class of equity owned by the controlling individual is separate from the class owned by those arm's length persons, as if those classes of equity were one class;

3. the controlling individual deals at arm's length with the organization; and

4. none of the main purposes of the controlling individual in the acquisition or holding of the investment by the registered plan is to obtain an advantage (other than income or capital gains on the investment).

We recognize that the application of the above four tests may present some complexity, particularly in comparison to entity-specific carve-outs or a more general relaxation of the prohibited investment definition. However, the most prevalent factor in the aggressive tax planning we observed in this area was the ownership and control of a significant portion of a particular business or fund. We are therefore recommending a test of general application intended to enable the small number of registered plan investors who technically have a prohibited investment to nonetheless demonstrate (based on these four tests) that they have a portfolio-style interest in a particular qualified investment and that they are not in a position to manipulate the valuation or income distribution in respect of that investment. This test avoids creating a special exception for any particular category of qualified investments, providing a more neutral basis on which to satisfy the policy objectives. At the same time, the test is easier to satisfy in that it focuses on the relationship between the controlling individual and the organization and less on the relationships between the controlling individual and others.

Fund start-up and wind-up

Another issue that is related to the definition "prohibited investment" that has been raised by some stakeholders is the difficulty of avoiding "prohibited investment" status for the first few investors, or the last few investors, in an investment fund that is intended to be (or was) widely-held. Existing paragraph 5000(*b*) of the Income Tax Regulations provides a time-limited exclusion from the prohibited investment rules for mutual funds that substantially comply with National Instrument 81-102 of the Canadian Securities Administrators (NI 81-102). This exclusion accommodates traditional mutual fund investments in their start-up phase, where potentially a relatively small ordinary course investment by a registered plan could represent over 10% of a mutual fund for a temporary period. Based on representations received since Budget 2011, we are prepared to recommend two expansions of this exception. First, we will recommend that this measure also apply in respect of registered investments (which are required to hold only qualified investments for the type of registered plan in respect of which they are registered) provided that they meet a basic diversification test and are not established with a tax avoidance objective. Second, we will recommend that this exclusion be expanded to also accommodate a reasonable winding-up period for the funds (i.e. NI 81-102 funds and registered investments) that qualify for the start-up period exclusion. We anticipate that this could be accomplished by adding a reference in subparagraph 5000(*b*)(ii) to the last two taxation years that precede the dissolution of an NI 81-102 mutual fund trust or corporation, or a registered investment, to the extent that that dissolution was planned to occur during that period.

Uncertainty of "open market"

You highlight the potential uncertainty regarding the meaning of the phrase "would not have occurred in an open market" in paragraph (*b*) of the definition "advantage" in subsection 207.01(1). We recognize that the phrase is potentially quite broad (if interpreted as only excluding transactions on stock exchanges) and has created some uncertainty. The term is intended to describe a transaction that does not occur on a commercially reasonable basis (such

as one, for example, in which the parties are acting in concert to achieve a tax benefit). The term is intended to focus on transaction terms that are not commercially reasonable having regard to all the circumstances. We will therefore recommend that clause (*b*)(i)(A) be amended to refer to a transaction or event or a series of transactions or events which would not have occurred in a normal commercial or investment context where parties deal at arm's length and act prudently, knowledgeably and willingly.

We note, however, that in policy terms, this clarification will not accommodate estate freeze transactions, which generally involve the creation and issuance of a nominally-valued class of shares in a business with significant value, and which could not be considered commercially reasonable transactions for the purposes of these rules. In fact, such estate freeze transactions involve a type of internal capital restructuring to which the advantage rules were designed to apply in the registered plan context.

Definition "swap transaction"

You raise a number of concerns with the definition "swap transaction". We consider the effective prohibition on swap transactions to be an important improvement to the integrity of the registered plan regime, and we do not foresee a practical manner of distinguishing between occasional transactions in respect of which valuation is readily, objectively, and prospectively established, and those in which often minor changes in the value – or trading price – are exploited for tax planning purposes. We also note that taxpayers may still achieve similar results – without the tax planning benefits – by selling one property outside their registered plan and acquiring it on the open market inside their registered plan. However, we do agree that the exception in paragraph (*c*) of the definition "swap transaction" could be more clearly worded to ensure that both the removal of the prohibited or non-qualified investment, and the transfer in, generally of cash, on a swap to remove a prohibited investment is properly excluded from the ambit of the definition "swap transaction". We are prepared to recommend an amendment to clarify this intended result.

Property becoming a Prohibited Investment

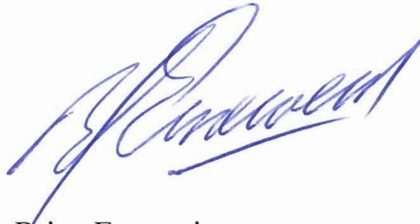
Your submission notes that a deemed disposition rule for investments that become prohibited would help the rules operate more clearly. We agree that a deemed disposition and reacquisition of a property at the time immediately before it becomes a prohibited investment – similar to the existing rule in subsection 207.04(5) that applies when a property ceases to be a prohibited investment – would provide clearer results, consistent with the policy intent of the measures, and we will recommend the introduction of such a rule.

Conclusion

We would recommend that all these amendments apply generally after March 22, 2011 and that they be included in a package of technical amendments that we would propose for release for comment at an early opportunity. Given that these rules generally apply also to tax-free savings accounts (TFSAs), we will recommend that the above changes apply also in the TFSA context where relevant. We trust this statement of our intentions is helpful.

Finally, I note that we have also been involved with discussions with a number of other organizations in relation to issues relating to the prohibited investment rules, and that these other organizations will have an interest in the comments we are providing in this letter to you. Accordingly, I have taken the liberty of copying each of these organizations on this correspondence. We look forward to continuing the helpful dialogue we have with the Joint Committee regarding Canadian income tax law and policy matters.

Yours sincerely,



Brian Ernewein,
General Director, Legislation
Tax Policy Branch

c. Ms. Joanne De Laurentiis, Investment Funds Institute of Canada
Ms. Katie A. Walmsley, Portfolio Management Association of Canada
Mr. Ian Pember, Alternative Investment Management Association