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mcmillan tax bulletin

budget 2011: proposed changes target abuse of RRSPs and RRIFs

In response to concerns about the increased use of registered retirement savings plans ("**RRSPs**") and registered retirement income funds ("**RRIFs**", and collectively with RRSPs, "**Registered Plans**") in abusive tax-avoidance arrangements, Budget 2011 proposes a number of legislative changes to the *Income Tax Act* (Canada) (the "**Tax Act**") to strengthen and update the anti-avoidance rules applicable to such plans. The proposed changes are based on the existing anti-avoidance regime applicable to tax-free savings accounts ("**TFSAs**") and rely on three overlapping sets of rules (i) the "advantage" rules, (ii) the "prohibited investment" rules, and (iii) the "non-qualified investment" rules, to deter the annuitant of a Registered Plan (an "**Annuitant**") from using the plan to engage in tax-avoidance transactions.

"advantage" rules

The proposed changes will amend the existing "advantage" rules applicable to TFSAs to apply to Registered Plans. Under the amended rules, an Annuitant (or, in some circumstances, the issuer/carrier of a Registered Plan) will be subject to a penalty tax equal to 100% of the fair market value of any "advantage" received by the Annuitant, the Registered Plan or any other person who does not deal at arm's length with the Annuitant in relation to the Registered Plan. The 100% penalty tax is aimed at discouraging Annuitants from engaging in transactions intended to obtain "advantages".

The proposed changes will amend the existing definition of an "advantage", currently applicable to TFSAs, to apply to Registered

Plans. This definition is quite broad and will include benefits obtained from a variety of transactions intended to exploit the tax attributes of a Registered Plan (including, but not limited to, certain tax-motivated non-arm's length and swap transactions intended to shelter income within a Registered Plan, income and capital gains from "prohibited investments", and certain income and capital gains from non-qualified investments).

The definition of an "advantage" will also be expanded to target so-called "RRSP strip" transactions. An "RRSP strip" will include any transaction or event, or a series of transactions or events (other than pursuant to the Home Buyers' Plan or the Lifelong Learning Plan), one of the main purposes of which is to enable the Annuitant, or a person who does not deal at arm's length with the Annuitant, to use or obtain property held in connection with the Registered Plan without including the value of the property in a taxpayer's income. Under the proposed changes, the definition of an "advantage" will include the reduction in value of property that is reasonably attributed to an "RRSP strip". This is an expansive anti-avoidance rule and will provide another highly visible basis upon which the Canada Revenue Agency (the "**CRA**") may contest the tax results of RRSP strip transactions in the future. (To date, the CRA has consistently sought to reassess taxpayer, based on the existing provisions of the Tax Act, to disallow the asserted tax benefits of certain RRSP strip transactions.)

"prohibited investment" rules

Budget 2011 also proposes to extend the existing "prohibited investment" rules, currently applicable to TFSAs, to Registered Plans. Under the proposed changes, an Annuitant will be liable for a penalty tax where a Registered Plan acquires a "prohibited investment" (or where an investment becomes a "prohibited investment"). The penalty tax will be equal to 50% of the fair market value of the investment at the time it was acquired (or at the time it became a "prohibited investment") and will be refundable if the "prohibited investment" is disposed of by the Registered Plan by the end of the year following the year in which the tax applied (or such later time as the Minister of National Revenue considers reasonable), unless the Annuitant knew, or ought to have known, at the time the investment was acquired, that it was, or would become, a prohibited investment.

In very general terms, a “prohibited investment” will include debt of an Annuitant (other than certain insured mortgages) and investments in entities in which the Annuitant or a non-arm’s length person has a “significant interest” (generally 10% or more) or with which the Annuitant does not deal at arm’s length. This legislative change may have adverse implications for Annuitants who hold (either on their own, or together with non-arm’s length persons) significant interests in corporations, trusts and partnership and who hold investments in respect of those entities in their Registered Plans.

The “prohibited investment” rules also interact with the “advantage” rules described above. In addition to the 50% penalty tax applicable to an Annuitant in respect of a “prohibited investment”, any income (including capital gains) derived, directly or indirectly, by a Registered Plan from a “prohibited investment” will be considered an “advantage” in respect of the Registered Plan, and the Annuitant will be subject to a penalty tax equal to the value of that “advantage”.

“qualified investment” rules

The Tax Act generally limits Registered Plans to investing in property which is a “qualified investment” for the purposes of the Tax Act. Under the current rules, a Registered Plan which holds a “non-qualified investment” (i.e., an investment that is not a “qualified investment”) is subject to tax on the income earned on such investments. In addition, where a “qualified investment” held by a Registered Plan ceases to be a “qualified investment”, a penalty tax will be applicable equal to 1% of the fair market value of such investment at the time it was acquired for each month that it is held by the Registered Plan. If a Registered Plan acquires an investment that is a non-qualified investment at the outset, the fair market value of such investment is included in the income of the Annuitant. (If the Registered Plan subsequently disposes of the non-qualified investment, the Annuitant is generally entitled to a deduction equal to the lesser of the amount of the income inclusion and the proceeds of disposition of the non-qualified investment).

Budget 2011 proposes to replace the current "non-qualified investment" regime described above with a penalty tax payable by the Annuitant equal to 50% of the fair market value of a non-qualified investment at the time it was acquired by the Registered Plan (or at the time it becomes a "non-qualified investment"). As with the penalty tax on "prohibited investments", this penalty tax will be refundable when the Registered Plan disposes of the "non-qualified investment", unless the Annuitant knew, or ought to have known, at the time it was acquired, that the investment was, or would become, a "non-qualified investment".

In order to prevent possible double taxation, where an investment is a "prohibited investment" and a "non-qualified investment", such an investment will be deemed not to be a "non-qualified investment" for the purposes of determining liability for the penalty tax. Investment income earned on a non-qualified investment by a Registrant Plan will remain taxable to the Registered Plan.

Although, relative to the existing "qualified investment" regime, this change may produce harsh results for an Annuitant who intentionally acquires a "non-qualified investment" or an investment knowing that it will become a "non-qualified investment", it is arguably more forgiving for an Annuitant whose Registered Plan inadvertently acquires, or holds, a "non-qualified investment".

application of the proposed changes

Budget 2011 proposes that the announced changes will generally apply to transactions occurring, and investments acquired, after March 22, 2011, subject to two transitional rules that apply specifically to (i) certain swap transactions undertaken by Registered Plans, and (ii) the application of the penalty tax in respect of "prohibited investments" that were held prior to March 22, 2011. These transitional rules will fully expire at the end of 2012.

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a cautionary note