INVESTMENT INDUSTRY ASSOCIATION OF CANADA

ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

Bill C-13 Recommendations –
RRSP/RRIF Anti-Avoidance and Other Rules

Submission to

the Chair and Members

House of Commons Standing Committee on Finance

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The Investment Industry Association of Canada (IIAC)[1] would like to provide comments regarding the proposed anti-avoidance and related rules with respect to registered retirement savings plans (RRSPs) and registered retirement income funds (RRIFs) in Bill C-13, *An Act to implement certain provisions of the 2011 budget as updated on June 6, 2011 and other measures*, known for short as the *Keeping Canada's Economy and Jobs Growing Act* (Bill C-13), introduced in Parliament on October 4, 2011. As IIAC represents broker-dealers, whose clients include an important portion of Canadian investors and issuers in this country, our comments reflect our members' experience with Canadians' and Canadian companies' needs and concerns, as well as our members' ability to meet reasonably the requirements of the proposed rules.

We agree with Department of Finance and Canada Revenue Agency (CRA) concerns with some swaps that have been undertaken, and agree with the need for anti-avoidance rules to address them.

We believe, however, that measures taken to prevent those who deliberately try to take advantage of the tax laws beyond what was intended should not be implemented at the expense of taxpayers trying legitimately to accumulate savings for retirement or to issue shares for productive capital investment. Millions of Canadians hold approaching $700 billion in RRSPs and RRIFs.

Below is background, followed by our comments and recommendations in three areas:

1. Prohibited investments
2. Non-qualified investments
3. Swaps.

Background

To address 'abusive' tax avoidance, the proposed changes in Bill C-13 will 'discourage' transactions that have been used for many years by ordinary Canadians without the intent of not paying their fair share of taxes through amendments in three areas:

- Proposed changes to the ***advantage rules*** will subject annuitants (RRSP- or RRIF-holders) to a penalty tax equal to 100% of the fair market value of any "advantage" received by the individual, his or her RRSP or RRIF (registered plan) or another person with whom the individual does not deal at arm's length. These advantages often pertain to swaps, that is, "transfers of property [e.g., securities] between the registered plan and its controlling individual or a person with whom the controlling individual does not deal at arm's length," for example, between an RRSP or RRIF (registered account) and a non-registered (non-tax-advantaged) account.

[1] The IIAC advances the growth and development of the Canadian investment industry. We represent the interests of our registered dealer members on securities regulation, tax and other public policy matters to improve the savings and investment process and to achieve efficient, liquid, competitive markets that benefit the investing and issuing public. Our 180 member firms range from regional institutional boutiques and small retail firms to large full-service companies employing thousands of Canadians across the country.

We believed that the RRSP/RRIF anti-avoidance rules announced in the 2011 Budget, patterned on similar rules introduced in 2009 for tax-free savings accounts (TFSAs), were aimed at stopping intentional efforts to take inappropriate advantage of the tax plans (e.g., by deliberately over-contributing or by frequent transfers in and out of the registered plan allowing the plan to grow tax-free as the frequent flips took advantage of price fluctuations). Following the release of draft legislation in late summer, our members, other financial institutions and the tax practitioner community learned that the intention was otherwise. Bill C-13 fully prohibits swaps with limited exceptions, due to the challenge in identifying abusive swaps contrary to the spirit of the *Income Tax Act* (ITA). This means, for example, that swaps to enable an investor to get emergency cash from an RRSP or to make the minimum required cash payment from a RRIF without selling a security that has dropped significantly in value are no longer possible.

- Proposed changes to the ***qualified investment rules*** will change the penalty tax regime applicable to non-qualified investments in a registered plan. Specifically, the 1% per month tax is to be levied against any non-qualified asset held on March 22, 2011 and earlier, and a one-time tax will apply at a rate of 50% of the value of assets acquired after March 22, 2011.

- New ***prohibited investment rules*** make RRSP- or RRIF-holders liable for a 50% of fair-market-value refundable penalty tax on a prohibited investment acquired by a registered plan or when such an investment becomes "prohibited" (i.e., where a client has more than a 10% interest or there is a non-arm's-length relationship). In addition to the 50% penalty tax, any income paid directly or indirectly to the registered plan from a "prohibited investment" will be considered an "advantage", and the RRSP- or RRIF-holder will be subject to a penalty tax equal to 100% of the income.

- There are ***transitional rules,*** however, in general the changes apply to transactions occurring, and investments acquired, after March 22, 2011.

  One of the proposals' transition periods was almost over by the time the Budget passed in June, summer holidays followed, highly technical draft legislation was released in August and there continue to be discussions about possible changes to the proposed rules. As of yet, there still has been no public communication that we are aware of regarding the implications of the anti-avoidance proposals that are affecting those Canadians not seeking to avoid paying the taxes that they should, thus many Canadians who may be affected likely remain unaware of Bill C-13's implications – and may not know until "RRSP season" early in the New Year or when they need emergency cash. While there is provision for relief after the fact, this is not popular for many taxpayers. As will be appreciated, there are public relations issues associated not only with RRSP- and RRIF-holders to be dealt with, but also with companies relying on private placement (and even public) funding.

Bill C-13 includes amendments to the draft RRSP/RRIF rules issued in August 2011 that address some concerns raised, but key issues remain unaddressed. To echo just one tax bulletin, the fact that certain changes were considered necessary "… arguably highlights the general concern raised by members of the tax community regarding the RRSP/RRIF Rules, namely that the rules

are broad enough that, in the absence of specific exclusions, they may inadvertently be applied to transactions that are neither tax motivated, nor abusive from a tax policy perspective."[2]

1. Prohibited Investments

Some of the qualified assets that Canadians hold in their RRSPs and RRIFs became, as of March 23, 2011, "prohibited investments." These include, in certain cases, shares of small businesses and mutual funds, including trusts and corporations. This change subjects these investors to immediate tax on income and capital gains earned on these investments.

Investors in start-up companies that received initial capital risked by management and directors for shares held in their RRSPs, who have seen their non-arm's-length investments rise significantly in value in their RRSP or RRIF, would have to remove these shares or incur penalties as these investments may now be prohibited. Such investors may be forced to sell the position, possibly sending a negative sign to the market and damaging the company's prospects.

In the case of some mutual funds, it will be impossible for RRSP- and RRIF-holders to know if they are offside or not. They can become offside and go back onside as individuals purchase and sell the units or shares. Moreover, they do not represent the risks of avoidance due to the significant regulation of National Instrument 81-102 mutual funds, including as regards concentration, control, illiquid asset holdings, conflict of interest reviews, etc. – in other words, the most common form of investment funds held most widely by retail investors.

We request that the Committee recommend two amendments to Bill C-13:

(i) Provide a grandfathering period during which the income and gains on qualified investments that became prohibited investments without advance notice as of March 23, 2011 are not subject to tax.

(ii) Exempt National Instrument 81-102 funds from the prohibited investment rules.

While transition rules reduce the amount of the tax for some years, investors will later be penalized and these changes should benefit both retail investors and small business owners.

2. Non-Qualified Investments

The non-qualified regime has been in place for many years. Bill C-13 proposes changes to how non-qualified investments are subject to penalty taxes. In some cases, these changes are effective March 23, 2011. Now six months later, with the tax year-end only two months away, we believe that neither financial institutions nor the CRA are ready for some of the changes required by Bill C-13, particularly as some of the new requirements will be very challenging (and in one case virtually impossible) to implement. This is due to outstanding questions, expected amendments to the proposals, and the extent of required systems and procedural changes.

[2] MacMillan LLP, October 17, 2011.

- ***For financial institutions:***

  Three-quarters of IIAC members are small businesses by StatCan's definition. In August, Minister Bernier re-announced the federal Red Tape Reduction Commission with a focus on small businesses. Our March 31, 2011 submission to the Commission strongly recommended the upfront provision of administrative relief in cases where it is essentially impossible to achieve full compliance due to the receipt of information later than required for development of systems changes cost-effectively.

  Moreover, we believe that considerably more implementation work will be required for RRSPs and RRIFs than for TFSAs due to the age of existing RRSP/RRIF systems and as there are currently more than 40 times the value and double the number of RRSPs and RRIFs compared to TFSAs. Pending answers to a series of questions posed to Finance and the CRA, most work to date necessarily has been targeted at stopping swaps rather than developing systems when it is uncertain what is required.

  In particular, the 1% per month tax is to be levied against any non-qualified asset held on March 22, 2011 and earlier, and a one-time tax will apply at a rate of 50% of the value of assets acquired after March 22, 2011. To track both types of assets – on-or-before-March-22- and after-March-22-acquired investments – will require systems changes and significant ongoing effort, particularly as a single account can end up with both "1%" and "50%" non-qualified holdings. In fact, an account can hold "1%" and "50%" non-qualified holdings *in the same security* due to different purchase dates. Other issues to be resolved include how to process reversals of taxes already applied and what gets sold first – old or new shares – or whether the client chooses.

- ***For the CRA:***

  Our members understand that the CRA has similarly not had time to begin operationalizing receiving reporting from financial institutions, informing investors of their requirement to pay the penalties, etc. Currently financial institutions collect and remit to the CRA the 1% monthly tax (which they will have to refund retroactively) and the CRA will have to start charging 50% on fair market value, as well as potentially increased staffing to adjudicate whether to waive or cancel the liability in relevant cases.

  We understand the CRA has identified that workarounds that would be required in the first year at least, and possibly longer. It is possible that this may result in an inability to receive effectively and use productively what information is provided. As an example, the proposal to provide copies to the CRA of letters sent to clients advising them that an investment is now non-qualified do not, due to requirements of the Office of the Privacy Commissioner of Canada (OPC), include the clients' social insurance numbers. For the CRA to receive copies of letters without SINs will make the CRA's task of data entry and reconciliation much more challenging and impractical.

We request that the Committee recommend two amendments to Bill C-13:

(i) Delay in requirements of financial institutions and the CRA for effect January 1, 2013 and

(ii) Continuing application of the rate of 1% on the fair market value of non-qualified investments until the end of 2012, followed by the application of a 50% or single other special tax rate on all non-qualified assets as of January 1, 2013.

3. Swaps

We believe that Department of Finance staff would likely agree that there may be many, possibly the majority of, swaps that would not be considered offensive from a policy perspective. They and the CRA reasonably are concerned with the ability to identify and stop the unacceptable transactions. In our view, not only are the vast majority likely to be legitimate, but preventing them will be problematic for many Canadian investors.

While the RRSP/RRIF rules are patterned on the TFSA rules, TFSAs allow for the equivalent of a swap by permitting withdrawal of a property in kind at the end of December and its replacement with a new property in early January. RRSPs and RRIFs lack a similar mechanism, and using trades instead (if this is possible[3]) exposes investors to price-change, foreign-exchange risk and additional transaction costs not incurred with a swap journal entry.

Moreover, the trust nature of registered plans can cause problems. A swap transaction possible for an RRSP- or RRIF-holder client of an investment dealer when buying a security of a company for which the dealer either acts as underwriter or helps distribute private placements is *not* possible through a swap when the RRSP- or RRIF-holder buys such securities underwritten or placed by a *different* investment dealer.

Although officials said that a client could engage in the swap, pay a penalty and apply for relief under subsection 207.06(2) – waiver of tax payable – the wording in the Budget, effectively required investment dealers to put in place systems to prevent all swaps. This means that a retroactive claim approach is not workable. In addition, it appears that the conditions in subsection 207.05(3) for waiver of the tax will require an income inclusion by the RRSP- or RRIF-holder – an undesirable result.

We request that the Committee recommend that Bill C-13 provide an additional transition period for all legitimate swaps to be permitted running from July 1, 2011 through December 31, 2012.

During the extended period, we hope to continue to work with Finance and the CRA to identify ways to allow the good and stop the bad transactions. During this interval, the CRA can challenge – as it has done successfully – transactions inconsistent with the intent of

[3] The sale by one account and purchase by another on the market (that is, on the TSX or TSX Venture exchange or a regulated alternative trading system) at the same price is not permitted under Investment Industry Regulatory Organization of Canada (IIROC) rules for accounts with the same beneficial owner. Known as "wash trading", this is seen as the effort by a party to influence the price of a security by creating trade volume (http://www.iiroc.ca/English/Documents/Rulebook/UMIR0202_en.pdf).

RRSPs and RRIFs, while the CRA and our industry build the necessary systems to apply the final amended provisions.

Conclusion

Many Canadians are investing in the markets due to the decline in interest rates and defined benefit plans over the past 20 years. The CRA this year issued additional information on TFSAs, highlighting clearly the confusion that can arise when there is a major change to tax-advantaged plans. These reasons make it all the more important, we believe, for the introduction of the RRSP/RRIF rules in Bill C-13 to be accompanied by a period of time to allow those who had invested legitimately, according to the rules in place for a considerable length of time, to arrange their financial affairs without undue penalties.

Recognizing the need for many parts of Bill C-13 to proceed, we recommend that relevant provisions in the 'Keeping Canada's Economy and Jobs Growing Act':

(i) Be severed for further work and re-introduced in legislation accompanying Budget 2012, or

(ii) Be replaced by a provision allowing the prescription of details in regulation, or

(iii) Be given an effective date of January 1, 2013, by which time the policy, implementation and other issues for Canadian seniors, small business owners, CRA and financial institutions can be addressed.

We believe that the public policy goal of encouraging and facilitating saving for retirement warrants changes to permit valid transactions and relief – particularly in the case of elderly people in retirement and people in situations where the problems described here could not have been foreseen – while preventing those abusing the intent of RRSPs and RRIFs.

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