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FINANCIAL ADVISORY SUPPORT

New RRSP/RRIF Anti-Avoidance Rules

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The 2011 federal budget proposed to enhance the existing RRSP/RRIF anti-avoidance rules to address concerns regarding the use of RRSPs/RRIFs in certain tax planning schemes. A number of these schemes involved accessing funds in RRSPs/RRIFs without including an appropriate amount in income or transferring value into an RRSP/RRIF without using up contribution room. The government viewed these schemes as being contrary to the intention and nature of the RRSP/RRIF concept. Consequently, one of the significant changes is that swaps between registered and non-registered accounts are no longer allowed except in very limited circumstances (discussed below). This means that the once widely used concept of rebalancing between an individual's registered and non-registered accounts is no longer allowed.

The proposed amendments generally apply after March 22, 2011, but there are special transitional rules that modify the tax consequences for prohibited investments that were held by an RRSP or RRIF at the time that the new anti-avoidance measures were announced.

At the date of writing, these proposals are contained in Bill C-13 that has gone through the 1st and 2nd reading in the House of Commons and on Thursday, November 3, 2011 has been agreed to without any amendments by the Standing Committee of the House of Commons. Since there is a majority government, these measures are very likely to be enacted.

Specifically, the proposed rules extend the application of the following Tax-Free Savings Account (TFSA) anti-avoidance rules to RRSPs and RRIFs:

- the advantage rules;
- the prohibited investment rules; and
- the non-qualified investment rules.

Advantage Rules

The proposed legislation adopts the "advantage" concept from the TFSA rules, with certain modifications.



In general, an “advantage” may be described as a benefit obtained from a transaction that is intended to exploit the tax attributes of a registered plan. This could potentially be achieved by shifting investment returns from a taxable investment account to a tax-deferred plan such as an RRSP/RRIF or a tax-free investment account, such as a TFSA. An example of this would be swapping a dividend paying stock into your RRSP/RRIF. The dividend is paid in your RRSP/RRIF and then the security is swapped back out of your RRSP. The tax on the dividend is deferred until you withdraw from your RRSP/RRIF but the actual security is outside of your RRSP/RRIF allowing you to take advantage of the lower tax rate on capital gains when you eventually sell the security – the best of both worlds.

The following will be included as an RRSP/RRIF advantage:

- Benefits derived from asset purchase and sale transactions (“swap transactions”) between RRSPs/RRIFs and other accounts controlled by the RRSP/RRIF annuitant or a non-arm’s length person. A swap transaction is a transfer of property, other than a transfer that is a contribution or a withdrawal, between an RRSP/RRIF and the annuitant or a non-arm’s length person. The definition of swaps will be discussed in greater detail below.

For swap transactions (or strip transactions done by way of a swap), the advantage is the increase or decrease in the total fair market value of the RRSP/RRIF due, directly or indirectly, to the swap transaction. Canada Revenue Agency has said that this is, in effect, a prohibition on swap transactions. They go on to say that the fact that the initial swap transaction may have occurred at fair market value is not relevant and that all future increases in the fair market value that are reasonably attributable to the initial swap transaction will be considered an advantage. Therefore, any dividends, interest or other amounts paid on the swapped security, any appreciation in value on the swapped security or on any substituted property, and any income earned on income, would be subject to the advantage tax.

- Benefits from “RRSP strip transactions”. These will generally be defined as any transaction or event (or series of transactions or events) where one of the main purposes is to enable the annuitant, or a non-arm’s length person, to use or obtain property held in the RRSP/RRIF (or substituted property) without including the value of the property in the annuitant’s income. Withdrawals under the Home Buyers’ Plan or Lifelong Learning Plan will still be allowed.

One example of an RRSP strip is a swap transaction that is undertaken to reduce the balance of an RRSP or RRIF. This can occur when a security is swapped out of an RRSP/RRIF on a day or at a moment when the value of the security is artificially low. Other examples of RRSP strips involve artificial loan transactions where there is no expectation that the loan will be repaid or that the annuitant or their nominee will be paid for services they have provided.

- Payments of investment income, where the income is tied to the existence of another investment. In the RRSP/RRIF context, the income affected by this rule may be either paid into the RRSP/RRIF, but tied to an investment outside the RRSP/RRIF, or paid outside the RRSP/RRIF, but tied to an investment inside the RRSP/RRIF. An example is the offering of two types of securities in tandem, where one is held inside an RRSP/RRIF and one outside, with a view to streaming the total investment return disproportionately to one or the other security.
- Income and capital gains derived from a “prohibited investment”.

- Benefits derived from transactions that would not have occurred in a regular, open market between arm's length parties, if it is reasonable to conclude that the transactions were undertaken to benefit from the tax attributes of RRSPs/RRIFs.
- Payments made to an RRSP/RRIF for services provided by the annuitant. This may be achieved by holding a special class of shares of your corporate client in your RRSP/RRIF. Instead of your client paying you for services, their corporation pays a dividend on the special class of shares you are holding in your RRSP/RRIF.
- Specified non-qualified investment income. This is defined as income and capital gains derived from non-qualified investments, which has not been removed from an RRSP/RRIF within 90 days of receipt of a notice from the Minister of National Revenue directing that the amount be removed.

The amount of tax payable in respect of an advantage will be, in the case of a benefit, the fair market value of the benefit and, in the case of a debt, the amount of the debt. In other words, an advantage is subject to a 100% tax on the value of the advantage. The tax will be payable by the RRSP/RRIF annuitant personally (not using the RRSP/RRIF funds), unless the advantage was extended by the issuer (or a person who does not deal at arm's length with the issuer) in which case the tax will be payable by the issuer. An example of an issuer is the financial institution where you hold your RRSP/RRIF.

The above definition generally applies to swap transactions occurring after June 30, 2011, however there are transitional rules with respect to swap transactions which are discussed in greater detail below.

Swap Transactions

Prior to these rules, some individuals were using swap transactions to transfer value either into or out of an RRSP/RRIF. In general, younger individuals could obtain tax benefits by increasing their RRSP balances to shelter more of their savings and investment income from tax, while older individuals could obtain tax benefits by reducing the balance of their RRSPs/RRIFs to reduce or avoid the income inclusion on withdrawal. These transactions generally involved taking advantage of securities volatile pricing. By transferring a security that was potentially worth more or less than its momentary trading price to or from an RRSP/RRIF, it was possible to create a shift in value of the difference between the purchase price and the actual value. This was viewed as being contrary to the original intent of the legislation with respect to RRSPs/RRIFs and consequently, swaps between registered and non-registered accounts are no longer permitted under the new anti-avoidance rules. However, there are a number of exceptions.

A "swap transaction" is defined in the legislation as a transfer of property between the RRSP/RRIF and the annuitant or a person with whom the annuitant does not deal at arm's length, but does not include:

- (a) A full or partial RRSP/RRIF withdrawal. This exception also includes transfers that occur when an individual is transferring their RRSP/RRIF from one RRSP/RRIF issuer to another.
- (b) A payment into the RRSP/RRIF that is a contribution or a premium and amounts transferred under other rules. This includes transfers from another RRSP/RRIF of the annuitant, a transfer to a spouse's or former spouse's RRSP/RRIF as a consequence of separation and transfers from a Registered Pension Plan.
- (c) A transfer of a prohibited investment or a non-qualified investment from the RRSP/RRIF in circumstances where the annuitant is entitled to a refund of the special 50% tax (discussed below) on the transfer.

- (d) Swaps between an individual's two plans of the same type, e.g. a purchase and sale transaction between an RRSP and an RRSP or an RRSP and a RRIF of the same individual (note that this includes locked-in RRSPs/RRIFs and spousal plans as long as the annuitant is the same). However, this does not include swap transactions between a TFSA and an RRSP or RRIF of the same individual.

The above definition generally applies to swap transactions occurring after June 30, 2011. However, a prohibited investment or a non-qualified investment can be swapped out of the RRSP/RRIF before 2022 even though the 50% special tax does not apply in some situations as long as it is reasonable to believe that the investment would be subject to the advantage tax and the 50% tax if it remained in the RRSP/RRIF. After 2021, prohibited investments and non-qualified investments can be swapped out of an RRSP/RRIF in order to remove it from the RRSP/RRIF long as the annuitant is entitled to a refund of the special 50% tax.

Prohibited Investments Rules

Bill C-13 introduces a “prohibited investment” concept for RRSP/RRIFs, based closely on the prohibited investment rules for TFSAs. A “prohibited investment” is defined in the Income Tax Act and generally includes debt of the annuitant and investments in entities in which the annuitant or a non-arm's length person has a “significant interest” (generally 10% or more ownership of the issued shares of any class of the capital stock of the corporation) or with which the annuitant does not deal at arm's length. Note that if you hold your mortgage in your self-directed RRSP/RRIF it is not considered a prohibited investment because insured mortgages are specifically excluded.

A special tax, equal to 50% of the fair market value of the investment, will apply to an RRSP/RRIF annuitant at the time that he or she acquires a prohibited investment in his or her RRSP/RRIF (or at the time that an investment becomes prohibited). The tax will generally be refunded if the prohibited investment is disposed of from the RRSP/RRIF by the end of the year following the year in which the tax applied (or by such later time as the Minister of National Revenue considers reasonable). The refund of the 50% tax is not available if the annuitant knew or ought to have known that the investment was a prohibited investment when it was acquired.

Income and capital gains derived from prohibited investments will be treated as an “advantage” and will therefore be subject to the 100% tax discussed above. Accordingly, any benefit of holding a prohibited investment in an RRSP/RRIF will be eliminated through the 100% tax on advantages.

Non-Qualified Investments Rules

Bill C-13 modifies the tax rules that currently apply when an RRSP/RRIF acquires a “non-qualified investment”. These modifications are based on rules that are already in place for TFSAs. Examples of non-qualified investments include shares in private investment holding companies or foreign private companies, and real estate.

Prior to these changes, if you acquired a non-qualified investment in your RRSP/RRIF, the value of that investment would be included in your taxable income. If that investment earned income inside your RRSP/RRIF, it would also be taxable to the RRSP/RRIF. In addition, a penalty tax of 1% per month also applied on the value of the non-qualified investment, while it remained in the RRSP/RRIF. If you subsequently disposed of the non-qualified investment from your RRSP/RRIF, you would receive a tax deduction for the lesser of the cost or proceeds of disposition of the investment.

Bill C-13 eliminates the income inclusion and deduction components of the current non-qualified investment rules, as well as the 1% per month tax. It is replaced by a special 50% tax based on the fair market value of the non-qualified investment. The RRSP/RRIF annuitant will be subject to the special 50% tax, which will apply at the time that a non-qualified investment is acquired by the RRSP/RRIF or at the time an investment becomes non-qualified. This tax will generally be refundable if the investment is disposed of from the RRSP/RRIF by the end of the year following the year in which the tax applied (or by such later time as the Minister of National Revenue considers reasonable). If the annuitant knew, or ought to have known, that the investment was non-qualified, the refund of the 50% tax will not be available.

Investment income earned on a non-qualified investment in an RRSP/RRIF will continue to be taxable to the RRSP/RRIF.

Any investment that would be both prohibited and non-qualified will be deemed to be a prohibited investment only and not a non-qualified investment.

Transitional Rules for Prohibited Investments

If you held a prohibited investment in your RRSP/RRIF on March 23, 2011, there are transitional rules that provide relief, up to the end of 2021, from the 100% advantage tax on income and capital gains where certain conditions are met.

Advantage Tax

The transitional rules for prohibited investments provide that the 100% tax on advantages will not apply to a “transitional prohibited investment benefit” under certain conditions. In particular, to be exempt from the 100% advantage tax, the annuitant must elect in prescribed form by the end of June 2012 to have this exemption from the advantage tax apply. In addition, the amount of the transitional prohibited investment benefit must be paid to the annuitant, as a normal withdrawal from the RRSP/RRIF, within 90 days after the end of the taxation year.

These RRSP/RRIF withdrawals will be taxable to the annuitant like normal RRSP/RRIF income for the taxation year in which the withdrawal is made. For example, the amount of a “transitional prohibited investment benefit” for 2011 that is withdrawn from the RRSP/RRIF in February 2012 will be income of the annuitant for 2012.

The “transitional prohibited investment benefit” for a particular year is calculated by the formula (A – B), where:

- A is the total income earned in the taxation year (and after March 22, 2011) on prohibited investments held on March 23, 2011, plus the capital gains that accrue after March 22, 2011 and are realized in the year
- B is capital losses that accrue after March 22, 2011 on prohibited investments held on March 23, 2011 and realized in the year.

The transitional prohibited investment benefit is calculated on an annual basis, and the capital loss offset does not include a carry-forward or carry-back mechanism. The last year that this transitional relief will be available is 2021. Therefore, it is necessary to dispose of the prohibited investment by the end of 2021 to avoid the 100% advantage tax on any appreciation in the value of the security. This can be done by sale, redemption or through a distribution in kind from the RRSP/RRIF. The transitional rules allow annuitants to swap the prohibited investment out of the RRSP/RRIF in exchange for cash or other property of equal value, but it must be done by the end of 2021.

It is important to note that although you are allowed to swap a prohibited investment out of your RRSP, it is not without tax consequence. Any accrued capital gain after March 22, 2011 to the date the security is swapped out would be deemed to be realized at the time it is swapped and must be included in your income. The entire gain is included in income and is not treated as a capital gain. The entire gain would be taxable at your marginal tax rate. For this reason, it is important to value any prohibited investments as at March 22, 2011.

Special 50% Tax

The special 50% tax on prohibited investments generally only applies if you acquire a prohibited investment in your RRSP/RRIF after March 22, 2011. However, if you acquired an investment before March 23, 2011 that subsequently becomes a prohibited investment on or before October 4, 2011 then the 50% tax will not apply. Note that any investment held in your RRSP/RRIF on March 23, 2011 that becomes a prohibited investment on any day from March 23, 2011 to October 4, 2011 will not be subject to the 50% tax; however, the annuitant will not be able to benefit from the “transitional prohibited investment benefit” rules. This means that they will be subject to the 100% advantage tax.

Only prohibited investments acquired for the first time by the RRSP/RRIF after March 22, 2011 and investments held before March 23, 2011 that become prohibited investments after October 4, 2011 will be subject to the special 50% tax.

Conclusion

If you are holding prohibited investments or non-qualified investments in your RRSP/RRIF or any other type of security that may give rise to an advantage as mentioned above, it is important to discuss these rules with your qualified tax advisor to determine your course of action. In addition, as a general rule, swaps between registered and non-registered accounts are no longer allowed except in very limited situations.



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