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NEW TAX PROPOSALS: SUMMER OVERLOAD

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When I want to know when major pieces of tax legislation are coming out, all I have to do is check my vacation schedule. Sure enough, on August 16 and 19, the government released over 400 pages of legislation and notes pertaining to part of the spring budget and long awaited revisions to the foreign affiliate rules.

RRSPs

As many readers will be aware, the federal Budget superimposed two new penalties, imported from the TFSA regime that would apply to RRSPs:

1. The "Advantage Tax". Subject to certain transitional rules, this tax[1] is designed to "expropriate" RRSP advantages, in the form of a 100% tax on benefits. "Advantage" is defined as a grab bag of transactions that seek to exploit the tax attributes of RRSPs (e.g., by shifting returns from a taxable investment to an RRSP).

Briefly, *some* of the transactions that will attract the Advantage Tax include a benefit that is an *increase* in the value of property held by an RRSP if it is reasonable to consider that the increase is attributable to:

- a transaction that would not have occurred in an open market in which parties deal at arm's length, if one of the main purposes of the transaction is to benefit from the RRSP exemption;
- payments that are tied to services or investments outside of the RRSP; or
- "swap transactions" —that is, transfers of property between the RRSP and the annuitant or a non-arm's length person.

Also subject to the Advantage Tax is income, including capital gains, from a prohibited investment (see below for further discussion). In this case, rather than expropriating the income, special rules may apply to impose a 42.9% tax to income or gains from a prohibited investment held on March 23, 2011[2] —but only until the end of 2016.

2. Tax on prohibited/non-qualified investments. The new provisions supplant the former income inclusion for non-qualifying investments,[3] so, instead, the annuitant will be subject to tax[4] of 50% of the fair market value of a non-qualifying or prohibited investment.[5] The tax will generally be refunded[6] if the investment is disposed of from the RRSP by the end of the year following the year in which the tax applied,[7] unless the annuitant knew or ought to have known that the investment was a prohibited investment when it was acquired.[8]

A non-qualified investment is an investment that is not included in the laundry list of qualified investments, which changes from time to time (real estate is one example). A prohibited investment generally includes debt of the RRSP annuitant, as well as investments in entities in which the annuitant or a non-arm's length person has a "significant interest" (generally 10% or more),[9] or with which the annuitant does not deal at arm's length.[10] (Note: A so-called "insured mortgage"[11] is exempt from the definition of "prohibited investment".[12])

The 50% tax on prohibited investments will not apply to prohibited investments that were held by the RRSP on March 22, 2011. However, income and capital gains on such investments after that date will nonetheless attract the Advantage Tax.

An important subset of prohibited investments pertain to significant interests in corporate equity. If an annuitant has shares or debt of a corporation in which he or she has a significant interest (generally 10% or more of the shares of any class),[13] the shares or debt of the corporation in question[14] will be a prohibited investment in an RRSP. In fact, there have been a few accounting-firm releases on this issue. As I said, investments that would otherwise be prohibited will be grandfathered from the tax on prohibited investments if held on March 22, 2011 (this is a change from the original Budget proposals). However, for such investments, a second penalty (the Advantage Tax) applies to income or capital gains to the extent that these are earned or accrued after March 22, 2011. In plain words, "the clock is ticking" on this element of the investment. So the Advantage Tax could apply to appreciation of the corporation's shares, dividends, or interest earned by the RRSP. As I said, the Advantage Tax is normally based on 100% of the income or capital gains, but is potentially subject to special rules in respect of prohibited investments held on March 23, 2011.

Transitional rules also apply to "swaps" with an RRSP (e.g., if you buy an investment from your RRSP, and so on). Swap transactions undertaken before July 2011 would not be subject to the Advantage Tax.[15] Furthermore, swap transactions undertaken to remove an investment that would otherwise trigger the Advantage Tax will be permitted until the end of 2012.[16] It also appears that a swap transaction does not include the transfer of a prohibited investment from an RRSP in order to obtain a refund of the tax on prohibited investments,[17] so there does not appear to be a time limit for this type of transaction.

One thing that you should keep in mind is that the new penalties do not completely replace the old ones: a number of pre-existing penalties survive. One example is that income from non-qualified investments will generally be taxable under subsection 146(10.1).[18] Also, the rules relating to overcontributions[19] are unchanged. If you want to know more about these proposals, there are updated sections in CCH's *Canada Income Tax Guide* and *Wealth Management Guide*. (See ¶25,385 and ¶151, respectively.)

In researching these updates, I found a potentially troublesome change. For investments acquired after March 22, 2011, the "charging section" for a qualified RRSP investment is changed from subsection 4900(12) to (14). However, the latter provision is subject to Regulation 5001, which creates prohibited investment status if qualified investment status depends "solely" on Regulation 4900(14). In this case, if the corporation ceases to qualify as a "specified small business corporation",[20] the investment will become a prohibited investment. What this seems to mean is that constant monitoring of the investment status will be required. Practically speaking, this change may often jeopardize the viability of investments in private company shares by an RRSP. Hopefully, this issue will be clarified shortly.

Foreign Affiliates

The second piece of draft legislation constitutes a major overhaul of the foreign affiliate rules.

Traditionally, these rules have been most relevant to public multi-national corporations and have spawned a cadre of international tax specialists. Having said this, many private-company advisers will have clients that have expanded outside of Canada into the United States or elsewhere (hereinafter referred to as "offshore").

Generally, these rules will make it more difficult to repatriate offshore profits by "streaming" tax-free exempt surplus dividends to Canadian corporate shareholders of a foreign affiliate. Although this should continue to be possible with offshore operating profits, a new surplus account—"hybrid surplus" —applies to dispositions of certain types of excluded property, which may include the sale of qualifying foreign affiliate shares (where the underlying assets are "devoted" to active business) or partnership interests. (Until the end of next year, the rules apply only to relevant dispositions between related parties.) By virtue of the hybrid surplus rules, a sale would generate 50% exempt surplus 3 (which in isolation can be repatriated tax-free) and 50% taxable surplus (which typically cannot). The problem is that the hybrid surplus account "bundles" these together so that they must be distributed on a *pro rata* basis. Formerly, to the extent that such a sale could generate exempt surplus, that portion could be streamed to Canada. The idea is to impose tax similar to a Canadian capital gain to the extent that the funds are remitted to Canada.[21]

Another provision that will make the repatriation of cash and other foreign assets more difficult is the new "upstream loan" proposal. It may be operative, for example, if a foreign sub repatriates profits to its Canadian parent as indebtedness to the sub—i.e., the sub simply "loans it up". The upstream loan rules work in a fairly similar manner to the shareholder loan rules in subsection 15(2). The general rule is that, to avoid an income inclusion, the loan must be repaid within two years after it is made,[22] and there is a series of loans and repayments override which knocks out this exception.

For indebtedness incurred before the Budget, the two year clock starts running at the date of the Budget. In other words, if corporations are indebted to their foreign affiliates such that the upstream loan rules potentially apply, they will have until March 22, 2013 to fix the problem.[23] If the funds were lent up because of a deficiency in surplus to "cover" the amount, this could prove to be problematic.

In many cases, particularly for "smaller" clients, offshore profits could often be moved to (or from) Canada simply by an intercompany advance account, perhaps "cleared off" periodically through a reversal to an exempt surplus dividend. These accounts must now be reviewed to ensure that they do not trigger the upstream loan rules; otherwise, the borrower could be subject to serious penalties.[24]

The foregoing are just a couple of foreign affiliate provisions that may be of interest to readers. A list of the major revisions can be found at the beginning of the explanatory notes to the legislation released on August 19, which is on the Department of Finance's website (www.fin.gc.ca/drleg-apl/fa-sea-0811n-eng.asp). But I would like to clarify one change that was not explicit in the summary: proposed subsection 90(2) provides that an amount received in the form of a *pro rata* distribution on a class of shares is generally deemed to be a dividend and thus subject to the foreign affiliate surplus regime. (Exceptions apply to distributions made either in the course of a liquidation and dissolution, or on a redemption, acquisition or cancellation of the share.) For example, a reduction of stated capital will be treated as a dividend. However, Regulation 5901(2) allows the recipient to bypass the normal surplus accounts by treating the dividend to be a return to cost base.[25]

Notes:

[1] Under section 207.05.

[2] If the annuitant elects before July of 2012, the special rules apply to income earned (or gains accrued) after March 22, 2011, if the income is earned (or gains are realized) before 2017. Under these rules, the income (or gains) will be subject to the 42.9% tax rate if they are paid from the RRSP within 90 days after the end of the year.

[3] See subsections 146(10) and (6). Also supplanted is the 1% per month tax, in section 207.1, for investments that "become" non-qualified.

[4] Under section 207.04.

[5] This applies either if the RRSP acquires a non-qualifying or prohibited investment, or the investment "becomes" non-qualified or prohibited.

[6] Pursuant to subsection 207.04(4).

[7] Or by such later time as the CRA considers reasonable.

[8] See subsection 207.04(4). For both taxes (i.e., the Advantage Tax and the 50% tax on prohibited or non-qualified investments), the CRA will have the authority to waive or cancel all or part of the tax if the CRA considers it just and equitable to do so.

[9] Of the shares of any class in the case of a corporation.

[10] Per subsection 207.01(1) (as would be amended by the 2011 federal Budget), a "prohibited investment" at any time means property (other than prescribed property) that is at that time: (a) a debt of the controlling individual of the registered plan; (b) a share of the capital stock of, an interest in, or a debt of either (i) a corporation, partnership, or trust in which controlling individual has a significant interest (as defined in subsection 207.01(4)), or (ii) a person or partnership that does not deal at arm's length with the controlling individual or with a person or partnership described in subparagraph (i); (c) an interest (or, for civil law, a right) in, or a right to acquire, a share, interest, or debt described in paragraph (a) or (b); or (d) prescribed property (see Regulation 5001, discussed later in the article).

[11] I.e., pursuant to Regulation 4900(1)(*j*.1).

[12] See Regulation 5000.

[13] In the case of a corporation, a "significant interest" (per subsection 207.01(4)) refers to a corporation in which the individual is a "specified shareholder" per subsection 248(1), e.g., such that shares held by a non-arm's length person count towards the 10% threshold, and the individual would also be a significant shareholder in corporations related to the corporation in question.

[14] Or a person or partnership that does not deal at arm's length with the annuitant or the corporation in question.

[15] See paragraph 53(6)(*b*) of the August 16 draft legislation.

[16] See paragraph 53(6)(*a*) of the August 16 draft legislation.

[17] I.e., under subsection 207.04(4).

[18] See, however, subparagraph (*b*)(iv) of the "advantage" definition in subsection 207.01(1).

[19] I.e., under section 204.1.

[20] The difference between a "small business corporation" and a "specified small business corporation" seems to be that, rather than requiring CCPC status, per the "small business corporation" definition, the corporation must be a Canadian corporation that is not directly or indirectly controlled by one or more non-residents.

[21] To me, these proposals seem to be at least somewhat inconsistent with certain recommendations made in 2009 by the Advisory Panel on Canada's System of International Taxation.

[22] Note that this differs from subsection 15(2), in that the latter limitation period is based on two years from the *end of the taxation year of the lender in which the loan was made*.

[23] There are certain exceptions in subsection 90(6) to (8); however, for many small business client situations, it is more a matter of "lucking in" to these provisions, than purposely planning into them.

[24] There is an exception for loans to other controlled foreign affiliates; however, in this case CFA status will be governed by section 17, which is a more restricted definition.

[25] As a dividend out of pre-acquisition surplus.