New Developments Regarding the Application of Registered Plan Advantage Rules

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Recent developments regarding taxes on investments placed in registered plans provide further guidance on the ways in which taxpayers can and cannot use these accounts to invest – and how the investment industry can ensure that plans are structured appropriately to maximize taxpayer returns while minimizing the risk of audit and reassessment. In particular, two significant updates have clarified the application of the advantage rules under Part XI.01 of the *Income Tax Act* (ITA) to:

1. Investment management fees paid by the planholder (rather than the plan); and
2. Expand the scope of what can be considered an "advantage" for the purposes of those rules.

For context, while earnings in registered tax-deferred or tax-free savings plans are, in principle, supposed to grow free of tax, taxes may still apply in limited circumstances, often as a result of what essentially constitute anti-avoidance provisions in the ITA. An advantage in relation to a registered plan may be subject to a tax of up to 100% of any benefit so received.

1. Department of Finance Rules on Investment Management Fees Paid Outside a Plan

A recent comfort letter issued by the Tax Policy Branch of the Department of Finance has settled a longstanding point of contention between the Canada Revenue Agency (CRA) and the investment industry regarding the treatment of investment management fees. This issue arose in November 2016, when the CRA took the position at a roundtable event hosted by the Canadian Tax Foundation that management fees paid by a registered plan holder (referred to as a "controlling individual" under the ITA) would constitute an advantage for the purposes of the ITA. CRA further took the position that the resulting benefit would include any increase in the value of the property held in the registered plan that resulted indirectly from the investment management fees – which could include all of the gains of the account.

Nearly three years after the CRA initially announced its position, the Department of Finance has issued a comfort letter advising that the intention was not to capture the

payment of registered plan fees from outside the plans, and recommending that the advantage rules be amended to clarify that payment of investment management fees from outside a registered plan does not constitute an advantage under the ITA. The CRA has confirmed it will administer the advantage tax rules in accordance with the comfort letter in anticipation of an amendment to the legislation. This confirmation should bring relief to investment managers and the planholders alike.

2. New Case Law Considering the Definition of an "Advantage"

The Federal Court of Appeal (FCA) recently considered the advantage rules in the case of *Louie v. Canada*, 2019 FCA 255, which overturned (in part) the Tax Court of Canada (TCC) decision in the *Louie v. R*, 2018 TCC 255, the first such case to consider the scope of the advantage rules.

The issue before the courts was the tax treatment of the increase in value of a Tax-Free Savings Account (TFSA) which had resulted from 71 swap transactions between the taxpayer's TFSA and other accounts. Through such transactions, the taxpayer increased the value of her TFSA from her initial contribution of $5,000 to over $200,000 by the end of the calendar year. She stopped undertaking any swap transactions in October 2009, when legislation was amended to explicitly prohibit such transactions. Although there was no specific prohibition on swap transactions at the time the impugned transactions were undertaken, the CRA took the position that the taxpayer received an advantage equal to the annual increase in the fair market value of the TFSA for the 2009, 2010, and 2012 calendar years, less the initial contribution of $5,000. The TFSA suffered a loss in fair market value in 2011, which meant that there was no assessed benefit for that year. At no relevant time were any gains or losses realized.

In the trial decision, Lamarre A.C.J. held that the taxpayer received an advantage in relation to her TFSA in 2009, but that she did not receive an advantage for the 2010 and 2012 years, since the purported advantages in those years resulted from natural market fluctuations. The FCA allowed the Crown's appeal in respect of the later 2010 and 2012 years, holding that the increase in the value of the TFSA for each year was indirectly attributable to the initial 2009 swap transactions because they provided the capital required to realize substantial gains for the TFSA. As such, the assessed benefits were taxable for each year (2009, 2010 and 2012) that there was a gain.

In practical terms, the decision of the FCA supports a calculation of the advantage tax that is equal to 100% of the unrealized gains attributable to the initial impugned investment without taking into account any unrealized losses. This punitive result is apparently intended and as such, advisors and investors should carefully review any transactions which may result in an inadvertent advantage.

By

Pamela L. Cross, Bhuvana Rai

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BLG Offices

Calgary

Centennial Place, East Tower
520 3rd Avenue S.W.
Calgary, AB, Canada
T2P 0R3

T 403.232.9500
F 403.266.1395

Ottawa

World Exchange Plaza
100 Queen Street
Ottawa, ON, Canada
K1P 1J9

T 613.237.5160
F 613.230.8842

Vancouver

1200 Waterfront Centre
200 Burrard Street
Vancouver, BC, Canada
V7X 1T2

T 604.687.5744
F 604.687.1415

Montréal

1000 De La Gauchetière Street West
Suite 900
Montréal, QC, Canada
H3B 5H4

T 514.954.2555
F 514.879.9015

Toronto

Bay Adelaide Centre, East Tower
22 Adelaide Street West
Toronto, ON, Canada
M5H 4E3

T 416.367.6000
F 416.367.6749