CRA Reviews Application of “Advantage Rules” to Investment Management Fees

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October 2018 Update

The Canada Revenue Agency (CRA) published a Folio on the advantage rules on October 1, 2018, entitled: "Income Tax Folio S3-F10-C3, Advantages – RRSPs, RESPs, RRIFs, RDSPs and TFSA" (the Folio). Paragraph 3.35 of the Folio indicates the application of the advantage rules to investment management fees is still under consideration by the Department of Finance and will be the subject of a later update to the Folio.

Introduction

On November 29, 2016, at a Canada Revenue Agency (“CRA”) round table hosted by the Canadian Tax Foundation, CRA representatives spoke to the application of the advantage rules to payments of management fees by the annuitant of an RRSP or RRIF or the holder of a TFSA (RRSP’s, RRIF’s, and TFSA’s are “registered plans”). At the round table, the CRA took the position that management fees paid by the registered plan annuitant or holder, referred to as the “controlling individual” under subsection 207.01(1) of the *Income Tax Act* (Canada) (“ITA”), constitute an advantage under Part XI.01 of the ITA. In particular, the CRA now considers the increase in value of property held in a registered plan that indirectly results from investment management fees being paid outside of the plan to likely constitute an “advantage”.

The “Advantage Rules” under the ITA and the CRA’s position:

Under section 207.05 of the ITA, a 100% tax is imposed on the fair market value of an “advantage” in relation to a registered plan that is extended to (or is received or receivable by) the plan holder or the registered plan itself (or anyone dealing at non-arm’s length with the plan holder). The penalty tax is payable by the plan holder, unless the “advantage” is extended by the issuer of the registered plan, in which case the penalty tax is payable by the issuer instead.

The term “advantage” is defined in paragraphs 207.01(1)(a) to 207.01(1)(e) of the ITA. If any paragraph applies, an “advantage” exists. At the round table discussion, the CRA referred to sub-paragraph 207.01(1)(b)(i) to support its new position. Under paragraph 207.01(1)(b), an “advantage” exists if a benefit results in an increase in the total fair market value of the property held in connection with the registered plan, and the increase in fair market value of the property can reasonably be considered to be attributable, either directly or indirectly, to at least one of four enumerated circumstances (found in sub-paragraphs 207.01(1)(b)(i) to 207.01(1)(b)(iv) of the ITA). Sub-paragraph 207.01(1)(b)(i) states:

(b) a benefit that is an increase in the total fair market value of the property held in connection with the registered plan if it is reasonable to consider, having regard to all the circumstances, that the increase is attributable, directly or indirectly, to

(i) a transaction or event or a series of transactions or events that

(A) would not have occurred in a normal commercial or investment context in which parties deal with each other at arm’s length and act prudently, knowledgeably and willingly, and

(B) had as one of its main purposes to enable a person or a partnership to benefit from the exemption from tax under Part I of any amount in respect of the registered plan…

The CRA’s position appears to be motivated by what it considers to be the commercial realities behind payment of management fees by controlling individuals. At the round table, a CRA representative took the position that it is not commercially reasonable for an arm’s length party to agree to pay the expenses of another party, and there is a strong inference that a motivating factor underlying the transaction is to maximize the savings of the plan so as to benefit from the tax exemption afforded to the plan.

Implications

Subject to the transition period provided by the CRA (discussed below), management fees paid by the controlling individual of a plan will be considered an “advantage”, subject to a tax of 100% of the fair market value of the advantage. To avoid the adverse consequences associated with this new position, any existing arrangements where management fees are charged directly to the plan’s controlling individual need to be changed so that the fees are charged to the registered plan. Should this result in an overdraft; the CRA has stated no adverse tax consequences will be assessed.

Transition Period

The CRA is currently working with the investment industry to identify different types of fee structures, and how the advantage rules will apply to these structures. To give the investment industry time to make the required changes, the CRA has stated that it will defer applying its new position until January 1, 2018. Management fees that are reasonably attributable to periods ending before 2018 and are paid by the controlling individual will have no adverse tax consequences. The CRA will be releasing a Folio on the advantage rules in early 2017.

By

Craig J. Webster, Joelle Kabouchi

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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

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