

Important CRA Update on 10/8 Plans

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I received the below memo discussing the decision of the Federal Court to quash previously issued orders requiring insurers to provide information on holders of 8/10 plans. The decision itself is most important of course, but also of interest is the additional information released in which it is stated that the CRA had previously determined that the 10 – 8 plan complied with the technical provisions of the Act and that GAAR could not likely be applied to redetermine the tax consequences of the plan. There is considerable additional commentary which will be of interest to those familiar with or seeking to learn more about how the plans work.

Federal Court Rules Against CRA's Misuse of Power

On November 1, 2011, the Federal Court quashed orders previously issued by the Court which authorized the Minister of National Revenue (the 'Minister') to require insurers who offer 'so-called' 10 – 8 plans to produce all information relating to such plans including the identities of all plan holders. ('Unnamed Person Requirements') This decision is noteworthy for two reasons:

- (i) It puts the Canada Revenue Agency ("CRA") on notice that the Court will not simply 'rubber stamp' attempts by it to pursue perceived tax policy objectives that are not mandated by the Income Tax Act (the 'Act') under the pretense of verifying compliance with the Act; and
- (ii) The information disclosed to the Court in the course of the judicial review provides a clear picture of CRA's position with respect to 10 – 8 plans.

Judicial Review

Applications for orders to authorize Unnamed Person Requirements were initially granted by the Federal Court in respect of RBC Insurance, Industrielle Alliance and BMO Life Assurance in the fall of 2009 and early in 2010. The Minister claimed that these orders were required in order to verify that the 10 – 8 plan holders were in compliance with the Act. Each of the insurers refused to provide the Minister with names or other identifying information relating to their 10 – 8 plan holders and filed motions with the Court to review these *ex parte* orders.

The insurers claimed that the Minister had not made full and frank disclosure to the Court of all relevant information at the time the applications were made. They submitted that such disclosure would show that the Unnamed Person Requirements "were issued for an improper purpose, namely a fishing expedition intended to chill their 10 – 8 business plans".

In her judgement, Madame Justice Tremblay-Lamer agreed with these submissions and cancelled the orders and awarded costs to the insurers. She found that the Minister fell short of her obligation to make full and frank disclosure in two respects. First, the Minister failed to disclose to the Court that the insurers had already provided 'a great deal of information' about their 10 – 8 plans before the Unnamed Person applications were made. She then went on to say:

"The second' and more troubling omission is the Minister's failure to disclose internal documents and information suggesting that the 10 – 8 plans comply with the letter of the Act, if not with its spirit. These documents – the bulk of which were only disclosed to the Insurers after two separate motions – are undoubtedly material and, had they been disclosed to the Court, could certainly have affected the outcome of the *ex parte* applications."

After repeated demands from the Court, the Minister finally and only reluctantly disclosed a significant amount of additional information including the following which the Court found to be 'material facts' germane to the case:

- (a) the fact that the Department of Finance had refused to amend the Act to address outdated policyholder provisions;
- (b) the fact that CRA had received a request for an advance income tax ruling which provided a great deal of information regarding a specific 10 – 8 plan for the express purpose of determining whether the plan complied with the Act;
- (c) the fact that the CRA had determined that the 10 – 8 plan complied with the technical provisions of the Act and that GAAR could not likely be applied to redetermine the tax consequences of the plan; and
- (d) the fact that CRA had made a decision to “send a message to the industry” by refusing to respond to the ruling request and to take measures to “chill” 10 – 8 business plans , in part by undertaking an “audit blitz”.

Madame Justice Tremblay-Lamer’s reasons for judgement are a scathing rebuke of CRA’s heavy handed methods for attacking 10 – 8 plans. She was satisfied that “the orders must be quashed solely because of incomplete disclosure”. However, she went on to comment that based on the evidence now before her, the primary goal of the Minister in seeking authorization for the Unnamed Persons Requirements was to chill the 10 – 8 business plans of the insurers’, not to verify compliance with the Act. She was also not satisfied that the Minister’s attempt to “send a message” was a valid enforcement purpose.

In her concluding remarks, Madam Justice Tremblay-Lamer chastised the Minister with the following statement:

“If, as the Minister’s delegates claimed in the internal emails, “Policy holder taxation is an area long overdue for attention”, then the manner in which it should receive this attention is through legislative amendment. It is a misuse of the Minister’s powers – powers which the Courts have repeatedly called “intrusive” – to use section 231.2 to pursue policy objectives rather than to enforce tax obligations. It was not open to the Minister to seek *ex parte* authorization under the pretence of verifying compliance with the Act when her true purpose was to achieve through audits what the Department of Finance refused to do through legislative amendment.”

These initiatives to go after 10 – 8 plans have been undertaken by CRA apparently based on unsubstantiated concerns that the plans are somehow offensive in tax policy terms. These tactics are particularly troublesome in light of the CRA’s own internal conclusions that the 10 -8 plans do not “result in a misuse of any provisions of the Act or an abuse of the Act when read as a whole”.

CRA's Position on 10 – 8 Plans

The 10 – 8 plan for which CRA received an advance ruling request appears to have been patterned closely on RBCI's Investment Credit Facility ("ICF"). In preparation for a review of this ruling request by the GAAR committee, senior officials of the rulings directorate at CRA prepared a detailed analysis of the tax consequences of the proposed 10 – 8 plan. (The CRA analysis and PPI's submission referred to below will be posted on PPI's website, along with the Federal Court decision.)

CRA's analysis, which was prepared in September 2008, in all material respects reaches the same conclusions as a submission that PPI made to CRA in March 2009 regarding RBCI's ICF plan. In summary, the analysis concludes that:

- (i) loans made under the program will not be "policy loans",
- (ii) an assignment of the insurance policy as security for the loans will not be a disposition of an interest in a life insurance policy,
- (iii) provided that the money borrowed under the program is used for the purpose of earning income the interest on the loan will be tax deductible,
- (iv) apart from a possible application of GAAR, the only manner in which the tax benefits to be realized under the program might be challenged is by denying a portion of the interest on the basis that the 10% rate is not reasonable.

After an exhaustive consideration of the possible application of GAAR, the analysis concludes with the statement that;

"As we are of the view that the facts and law in this case do not support the finding that the series of transactions being proposed result in a misuse of any provision of the Act or an abuse of the provisions of the Act when read as a whole, we do not believe that GAAR can be applied in this case."

Even faced with their own internal conclusions that the 10 -8 plans complied with all of the relevant technical provisions of the Act and that GAAR could not be successfully applied to the plans, CRA decided to attack anyway. As is evident from the evidence disclosed in the course of the judicial review, CRA attempted to "chill the market" and "send a message to the industry" by refusing to issue an advance tax ruling, making vague public announcements of their concerns with 10 – 8 plans and undertaking an "audit blitz" of 10 – 8 plan holders.

Reasonableness of Interest Rate

Throughout 2009 and 2010, in various public statements and several proposed assessments, the CRA has challenged the deductibility of interest by 10 – 8 plan holders (including ICF borrowers) on the basis that the amount claimed was in excess of a reasonable amount. In response to these CRA initiatives, in February 2011 PPI made a comprehensive submission to CRA demonstrating why the ICF interest rate

was then and always had been reasonable and reflected prevailing market rates for borrowers in similar circumstances and loans with similar terms and conditions.

PPI also commissioned an independent report from an experienced banking consultant on the question of whether the 9% interest rate then charged by RBCI on ICF loans was reflective of the current Canadian commercial market rate. The conclusions of the this report received in February 2011 were that the equivalent market rates for ICF loans in September 2006 and late 2010 would be somewhat in excess of the actual ICF loan rates in effect at those times.

In July 2011, PPI representatives met with senior officials of CRA to discuss their response to the submission. Based largely on comments provided by their Valuation Services Section, in a memo dated March 7, 2011 the CRA officials continued to maintain that a reasonable rate of interest for an ICF loan should not exceed a 'risk-free' rate represented by the yield on a Government of Canada 10 year benchmark bond. PPI fundamentally disagrees with this position and the rational used by CRA to arrive at their conclusion.

Following the July meeting, in September 2011 PPI provided CRA with a detailed memorandum elaborating on the issues discussed at the meeting and responding to the comments made by CRA's Valuation Services Section. (PPI's February 2011 submission, the CRA memorandum from the Valuations Services Section and PPI's September 2011 will all be posted on PPI's website.)

PPI's Position

As stated above, PPI's position is that the ICF interest rate is now and has always been reasonable and reflects prevailing market rates for borrowers in similar circumstances and loans with similar terms and conditions. The following factors provide strong support for this position:

- (i) RBCI has adopted a rigorous pricing methodology for ICF loans that is consistent with RBC's approach in pricing other commercial loans,
- (ii) The conclusions of the banking consultant's report that the equivalent market rate for an ICF loan in both 2006 and 2010 were actually slightly higher than the ICF loan rate, and
- (iii) A comparison of the ICF loan rate with the well-established Canadian residential mortgage market indicates that the comparable fixed rate for a CMHC insured (ie government guaranteed) mortgage with terms similar to the ICF would also be slightly in excess of the ICF interest rate.

The information which PPI has been able to gather on the reasonableness question also provides very strong support for the fact that the loan rates offered by Industrial Alliance on its comparable credit facility have been and continue to be reasonable.

CRA's Position

It is the CRA's position that a reasonable rate for an ICF loan should be in the range of a 'risk-free' rate represented by the yield on a 10 year Government of Canada bond. This position is seriously flawed for the following reasons:

- (i) CRA has characterized the ICF as an arrangement under which the debtor borrows his or her own money, as being 'risk-free' or as being 'guaranteed by cash'. Such characterizations are factually incorrect. RBCI as the ICF lender is exposed to credit risk as described in PPI's submissions,
- (ii) Even where a commercial loan may be fully secured, to conclude that a reasonable rate of interest should not exceed a 'risk-free' rate Government of Canada bond rate ignores the realities of the financial markets. While the value of the security assigned as collateral for a loan is one factor taken into consideration by lenders in pricing commercial loans, it is not the only and indeed not the primary factor. Lenders are much more concerned about evaluating the probability that a borrower may default on his or her obligations under a loan agreement and price accordingly regardless of the value of the security.
- (iii) CRA's position fails to recognize that ICF borrowers are either individuals or small and medium sized private companies. Such borrowers do not have access to public markets to issue their own securities and certainly are not in a position to borrow from commercial lenders at rates as low as the Government of Canada bond rate.

PPI submits that the CRA's view that the ICF loans have been structured to take advantage of the exempt life insurance policy tax provisions has led CRA to take an extreme position with regard to the reasonableness of the ICF interest rate. This position completely disregards the actual legal relationship between RBCI and the ICF borrower and completely ignores the realities of the financial markets. These points apply equally to the credit facility offered by Industrial Alliance.

We firmly believe that CRA's position as described above is untenable.