September 16, 2021

Via email: andrew.donelle@fin.gc.ca

Andrew Donelle
Director, Deferred Income Plans
Tax Legislation Division
Department of Finance
140 O'Connor St
Ottawa, ON K1A 0G5

Dear Mr. Donelle:

Re: Registered Pension Plan Borrowing Restrictions

The Canadian Bar Association Pension and Benefits Law Section (CBA Section) is pleased to comment on possible changes to the borrowing restrictions applicable to registered pension plans under paragraph 8502(i) of the *Income Tax Regulations* (ITR).

The CBA is a national association of over 36,000 members, including lawyers, notaries, academics and students across Canada, with a mandate to seek improvements in the law and the administration of justice. The CBA Section contributes to national policy, reviews developing pensions and benefits legislation and promotes harmonization. Our members are involved in all aspects of pensions and benefits law and include counsel who advise pension and benefit plan administrators, employers, unions, employees and employee groups, trust and insurance companies, pension and benefit consultants, and investment managers and advisors.

1. Background

We understand that Finance Canada believes the borrowing restrictions applicable to registered pension plans under paragraph 8502(i) of the ITR are out-of-date and should be amended or replaced.

Finance Canada asked for our views on the approach to amend these rules. On July 16, 2021, a working group of the CBA Section met with you and your colleague Zahra Haji to discuss how we could assist. At that meeting, you indicated a willingness to meet with the working group following receipt of our written submissions and prior to the release of any draft or final legislative changes. We believe that another meeting would be beneficial, and we look forward to our follow up discussions.

We understand that Finance Canada intends to make the new or amended borrowing rules *less* restrictive than the current rules. More specifically, we understand Finance Canada intends that the new rules will *not* prohibit or restrict any activities not currently prohibited or restricted under paragraph 8502(i). As mentioned during the July meeting, we support the position that any new or amended borrowing rule be less restrictive and not apply to activities beyond those currently subject to the restrictions in paragraph 8502(i).

2. Repeal borrowing rule

Prior to commenting on possible amendments to the borrowing rule, we wish to make an overarching comment about whether the task of regulating borrowing by pension plans should fall within the ambit of a taxing statute. In our view, the supervision of pension plan asset management, including borrowing, belongs more properly under the auspices of Canadian pension regulation. Canadian federal and provincial pension legislation and regulation includes general and specific requirements for investing a pension plan's assets prudently, and in conformity with specified limits and restrictions. The Canadian Association of Pension Supervisory Authorities recommends that:

> The investment management function should be undertaken in accordance with the prudential principles of security and cash flow management, using appropriate risk management concepts. The plan administrator needs to achieve a balance between risk and reward considerations.[1]

A role of the pension regulator is to monitor the administration and investment of the plan and its assets, taking into account the need for plan administrators to generate returns while reasonably limiting risk. Any guidelines on borrowing and the supervision of its use in accordance with prudential principles are best left to pension regulators. Accordingly, Finance Canada should consider removing borrowing rules from the ITR altogether.

The remainder of this submission comments on potential amendments to the existing borrowing rules in case an outright repeal is not adopted by Finance Canada.

3. Do not define "borrow money"

Based on our understanding of Finance Canada's intention to make new borrowing rules, if any, less restrictive than the current rules, we strongly recommend that any new borrowing rules not contain a definition of "borrow money".

There is already a well-established and consistently applied definition of "borrowed money." The leading decision is *Minister of National Revenue v. McCool*, [1950] S.C.R. 80 (*McCool*) where the Supreme Court of Canada stated:

> **Terms such as "borrowed capital", "borrowed money" in tax legislation have been interpreted to mean capital or money borrowed with a relationship of lender and borrower between the parties. It is necessary in determining whether that relationship exists to ascertain the true nature and character of the transaction.** In this case the promissory note arises out of an exchange in which, as already detailed, the purchase price was paid by assuming outstanding obligations, a small payment of cash, allotment of capital stock and the execution and delivering of this promissory note. Under such circumstances it cannot be held that the relationship of lender and borrower in respect to this note exists between the respondent company and the payee of the note. [emphasis added]

The reasoning in *McCool* has been consistently applied by courts and the Canada Revenue Agency (CRA).[2]

In addition to the definition of "borrowed money" being well understood and consistently applied by courts and the CRA, in our experience, this legal definition is also well understood by pension plans. Pension plans develop structures based on that definition – structures that last for many

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1 CAPSA Guideline No. 6 – Pension Plan. Prudent Investment Practices Guideline, at p. 3.

2 See, for example, *CRA Access Document 2013-0496841I7* and *Penn Ventilator v. The Queen*, [2002] 2 C.T.C. 2636 2002 D.T.C. 1498.

years and contractually cannot readily be unwound in many cases. Any attempt to define this term could result in the new rule being more restrictive than the current rule for the following reasons:

(a) it would not be possible for the definition to anticipate every new product that might be introduced in the future;

(b) any list of examples of activities not considered to be borrowing money could create an inference that any non-listed activities are in fact borrowing; and

(c) including a catch-all "as acceptable to the Minister" category in a list of activities that are not considered borrowing would create an undue administrative burden for plan administrators and the CRA: Plan administrators would need to write to the CRA/Minister each time there is doubt on whether a particular activity is borrowing money and the CRA would need to respond to those requests on a timely basis. There are often time constraints for pension investments and having to draft a submission and wait for a response from the CRA would not be feasible in many cases.

We therefore recommend that the new borrowing rule not contain a definition of "borrowing money" to prevent the new borrowing rule from becoming more restrictive than the current rule.

4. Apply borrowing rule only to defined contribution plans

We believe that if there is a borrowing rule in tax legislation, the rule should be properly calibrated to the purpose of the legislation. Although there is no legislative history evidencing the intent of ITR 8502(i), a clue about the purpose of a pension borrowing restriction in the tax rules can be found in Finance Canada's statements on the rules for pooled registered pension plans (PRPPs), which are similar to defined contribution pension plans. Under subparagraph 147.5(3)(g) of the *Income Tax Act*, borrowing money causes a PRPP to become revocable. The October 15, 2012 Technical Notes explain that this borrowing prohibition:

> […] is intended to prevent a PRPP from borrowing (for example, from the administrator or a person related to a plan member) in order to increase the total assets under management for the benefit of plan members. Such an arrangement could be used as part of an arrangement to effectively circumvent PRPP contribution limits by earning investment returns on behalf of PRPP members on money borrowed at favourable interest rates.

The CRA understands the borrowing restrictions in paragraph 8502(i) similarly: "if the Plan is a money purchase plan, the concern about leveraged investing takes on greater importance as the borrowing would have served in effect to circumvent the RPP contribution limits."[3]

The CRA contrasts this with a defined benefit plan, where leveraged investing is less of a concern as the tax rules provide for a self-adjusting mechanism: a higher rate of return resulting from leverage within the plan results in lower employer contributions. In light of the foregoing – namely that Canadian pension regulators are best positioned to regulate borrowing from a prudential perspective and that the mischief a tax borrowing rule might reasonably target is excess contributions to defined contribution plans – we submit that if Finance Canada believes it necessary to have a tax rule restricting pension plan borrowing, it would be appropriate (as a policy matter) for the rule to be limited to defined contribution plans.

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[3] CRA Doc. No. 2016-0644761I7 -- *RPP borrowing* (May 10, 2016).

5. Exemption for large plans

In the event the borrowing rule is not repealed in its entirety or limited solely to defined contribution plans, we support an exemption from the borrowing rule for certain large plans.

As a plan increases in size, both investment governance and risk management generally become more sophisticated and "blunt instrument" rules such as the borrowing rule become less necessary. As noted above, the prudential requirements of federal and provincial pension legislation and regulation give the basis for a more appropriate supervisory framework for asset management, including borrowing, by such plans.

While there are multiple compelling ways to craft an exemption, we believe an exemption for plans that have at least 50,000 members and $10 billion in assets under management based on book value (determined at the end of the immediately preceding tax year), would be appropriate.

This exemption would allow the plans to employ borrowing as part of their leverage strategies, in accordance with the pension benefits standards legislation of their jurisdiction, and allow them to prudently and flexibly manage their assets and liabilities to meet their obligations to their members. It would also put these plans on the same footing as the Canada Pension Plan Investment Board and the Public Sector Pension Investment Board, neither of which are subject to a borrowing restriction.

6. Borrowing restrictions for plans that are not exempt

For registered pension plans that continue to be subject to an amended borrowing restriction (Restricted Plans), we propose that exceptions to the general prohibition on borrowing in paragraph 8502(i) of the ITR be expanded to include a new exception based on a percentage of plan assets. Specifically, we propose adding the following new exception to the general borrowing prohibition:

> where the aggregate of all amounts of borrowed money does not exceed 20% of the fair market value of plan assets, calculated at the date of the latest borrowing.

A test based on a percentage of plan assets offers the advantages of fairness between different Restricted Plans, ease of implementation and clarity. This would be particularly so if the test was measured only at the time of borrowing.

Our suggested borrowing limit of 20% of the fair market value of plan assets is based on the following two assumptions:

(a) there will *not* be a definition of "borrow money" added to the ITR or the *Income Tax Act*;[4] and

(b) such limit does *not* include (i.e., is over and above) any borrowing for the purpose of acquiring real property as currently permitted under subparagraphs 8502(i)(iv) through (vi) of the ITR.

If one or both of these assumptions are inaccurate, the borrowing limit would need to be larger than 20% of the fair market value of plan assets. How much larger the limit would need to be would depend on how the borrowing rules are changed.

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[4] We acknowledge that subsection 248(1) of the *Income Tax Act* (Canada) contains a definition of "borrowed money" and are not suggesting that any change be made in respect of that narrow deeming rule which provides that "borrowed money" *includes* the proceeds from the sale of a banker's acceptance. Except with respect to such instruments, this rule does not modify or displace the case law meaning of "borrowed money".

7. Conclusion

The CBA Section appreciates the opportunity to offer these comments. We trust they are helpful and we would appreciate an opportunity to meet with you to elaborate further.

Yours truly,

(original letter signed by Marc-Andre O'Rourke for Level Chan)

Level Chan
Chair, CBA Pensions and Benefits Law Section