Inside out: Fees for registered plans

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If you pay fees for the management of your registered portfolio, be it a registered retirement savings plan (RRSP), registered retirement income fund (RRIF) or tax-free savings account (TFSA), these fees are not tax deductible. That being said, how should investment management fees[1] ("fees") for a registered plan be paid? Should they come from inside the registered plan or be paid using outside funds? This report will review the tax rules surrounding the payment of fees for registered plans, as well tackle the question of the best place to pay fees, based on a variety of factors, such as time horizon, rate of return and tax rates.

Background

In the fall of 2019, the government confirmed that fees can be paid by the RRSP or RRIF annuitant or TFSA holder from outside the particular registered plan without attracting penalty taxes. But, what exactly was the government's concern with paying those fees with outside funds? The answer lies in the "advantage rules" for registered plans.

The advantage rules

The advantage rules are a set of lesser known anti-avoidance rules that apply to registered plans. If you're caught by them, you could face particularly harsh penalties. Where a prohibited advantage has been received, a 100% penalty tax on the fair market value of the advantage applies.

These rules were originally introduced when TFSAs were launched out of concern there could be temptation for some Canadians to manipulate the completely tax-free nature of TFSAs. The rules were extended to RRSPs and RRIFs in 2011, and registered education savings plans (RESPs) and registered disability savings plans (RDSPs) in 2017. The Canada Revenue Agency (CRA) has described the rules as targeting "abusive tax arrangements that seek to artificially shift value into or out of a registered plan".[2]

There are a number of ways that an "advantage" can arise.

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[1] There are a variety of fees that may be associated with registered plans, such as annual administrative fees, commissions paid to buy or sell a security within the plan as well investment management fees. In this report, all references to "fees" refer to investment management fees, which was the focus of the Canada Revenue Agency's concerns.

[2] CRA Income Tax Folio S3-F10-C3, Advantages-RRSPs, RESPs, RRIFs, RDSPs and TFSAs which can be found on the CRA website at canada.ca/en/revenue-agency/services/tax/technical-information/income-tax/income-tax-folios-index/series-3-property-investments-savings-plans/series-3-property-investments-savings-plan-folio-10-registered-plans-individuals/income-tax-folio-s3-f10-c3-advantages-rrsps-rrifs-tfsas.html.

For example, if you receive a benefit only because you maintain an RRSP[3], then you could be considered to have received an advantage.[4] In addition, an advantage could result if you swap property between a registered plan and non-registered plan, even if done at fair market value, which is why most financial institutions don't permit investors to swap investments to or from registered plans.

Similarly, if you make a make a deliberate overcontribution to a TFSA (i.e. knowingly make a contribution that exceeds your contribution limit), this may be considered an advantage.

There are other situations where increases in the value of a registered plan can result in the advantage penalty tax rules coming into play. For example, this can occur where the increase can be linked to a transaction that reasonably would not have occurred in a "normal commercial or investment context," and a main purpose was to benefit from the tax-free status of the registered plan. It was this particular rule that caused the CRA to wonder whether the payment of fees outside of a registered plan should be considered an advantage.

Is a 100% penalty tax even constitutional?

In 2018, a taxpayer attempted to challenge the constitutionality of the 100% advantage tax.[5] The taxpayer was reassessed nearly $125,000 in penalty tax in connection with the transfer of private company shares to his TFSA. The first ground of his challenge was that a 100% tax "fell within the provincial jurisdiction of property and civil rights…since the 100 percent tax rate was a confiscation of property and was not necessary to the effective exercise of the federal taxation power as it overreached what was necessary to meet the aims of the section." His second argument was that because the CRA has the discretion to reduce the 100% advantage tax to zero, "Parliament…improperly delegated the rate-setting element of (tax)…to the (CRA)…in contravention of…the Constitution Act."

Perhaps not surprisingly, the court disagreed, concluding that the rule taxing the advantage at 100% did not infringe on the right to make laws respecting property and civil rights because the section was "in pith and substance" taxation and "fell within a valid TFSA scheme of taxation within a valid (Income Tax Act)." The Judge, upholding the 100% advantage tax, concluded, "The provisions are clear, were properly passed by Parliament into law…and are constitutionally valid." As such, it appears taxpayers need to understand, and avoid, being offside of the advantage rules.

Registered plan fees

A few years ago, the CRA commenced a review of the payment of fees for registered plan accounts, and specifically, looked at the question as to whether the payment of fees by the annuitant or holder outside of a registered plan, while certainly not tax deductible, gave rise to an "advantage" under the Income Tax Act. The CRA reasoned that there is an advantage since the payment of fees outside of the registered plan would lead to an increase in value of the property in the registered plan, one of the main purposes of which was to benefit from income and gains within the registered plan being exempt from tax. The financial services industry made various submissions to the CRA, explaining that this is not always the case, as will be seen in the examples below.

The decision

The CRA subsequently referred the matter to the Department of Finance, which responded that they did not have policy concerns with the payment of fees by the annuitant or holder outside of a registered plan, and that they were prepared to amend the law to ensure that the advantage rules would not apply to fees paid from outside of registered plan accounts by the annuitant or holder. The good news is that investors now have the opportunity to pay registered plan fees from their non-registered accounts without the fear of attracting the 100% advantage tax. This, of course, leads to the obvious question as to where such fees should be paid: inside or out?

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3 For simplicity, the term "RRSP" is used to mean an RRSP or RRIF and all information in this report about an RRSP applies equally to a RRIF.

4 There are certain exceptions permitted for regular investment activities and conventional incentive programs offered by financial institutions.

5 See Hunt v. The Queen, 2018 TCC 193.

Inside vs. outside

Intuitively, you might think that you would always be better off paying fees from outside the plan (i.e. using non-registered investments), as that leaves more money inside the plan to grow unencumbered by tax. That may be true for TFSAs, so that tax-free growth within the plan can be maximized; however, that's not necessarily the case for other registered plans. That's because when you pay a fee with non-registered funds (i.e. from outside the registered plan), you're paying with after-tax dollars. When you use RRSP funds to pay the fees, these are pre-tax dollars. In essence, the CRA is sharing in part of the fee. Let's take a look at an example.

Example

Suppose you incurred a $100 fee on your RRSP investments that you could pay from inside your RRSP or outside your RRSP (using non-registered funds.) You're in a 30% tax bracket.

By paying the $100 fee from outside your RRSP, you'd simply be out the $100. By paying the fee from within the RRSP, you'd only really be out $70. Why? Because you use pre-tax funds to pay fees from your RRSP but you use after-tax funds to pay fees from non-registered funds. With an RRSP, the government defers collecting tax on the funds you invest in your RRSP until the time you later withdraw those funds. If you paid the $100 fee from inside the RRSP, you never withdraw that $100, so the government never gets its 30% tax on the $100 and, therefore, shares in paying for your fee!

Since you'd have less cash in hand if you paid fees from outside your RRSP (from non-registered investments), rather than from inside your RRSP, you may well wonder why the CRA initially thought that paying RRSP fees from non-registered investments would be beneficial and potentially result in an unfair advantage, subject to penalty tax.

Long-term investing

While paying fees from inside an RRSP may yield some savings, as described above, you'd also have less funds in your RRSP, so you'd have less tax-deferred growth over time. You might eventually reach a "breakeven point," where the benefit of paying the fees from inside the RRSP is outweighed by the additional tax deferred RRSP growth that could have accumulated inside the plan. After this breakeven point, you'd actually have been better off if you had initially paid the fees from funds outside your RRSP, preserving the extra funds inside your registered plan.

Example of a breakeven point

Suppose Reza has $10,000 in her RRSP and $100 in non-registered investments. She pays a $100 fee for her RRSP account, has a 5% rate of return on investments, and has a 30% tax rate.

Figure 1: Reza's after-tax cash after 25 years, if the fee was paid from inside versus outside an RRSP

Description	RRSP (Fees paid inside)	Non-registered (Fees paid inside)	Total (Fees paid inside)	RRSP (Fees paid outside)
Initial balance	10,000	100	10,100	10,000
Fee	(100)	0	(100)	0
Balance after fee	9,900	100	10,000	10,000
FMV after 25 years (at 5%)	33,525	237[6]	33,762	33,864
Tax at 30% on RRSP withdrawals	(10,057)	n/a	(10,057)	(10,159)
After-tax cash	23,468	237	23,705	23,705

[6] Assumes annual tax is paid on the non-registered income earned each year.

Figure 1 shows Reza's after-tax cash if she paid the $100 fee at the beginning of the first year, from inside versus outside her RRSP, and then cashed out all her investments at the end of 25 years.

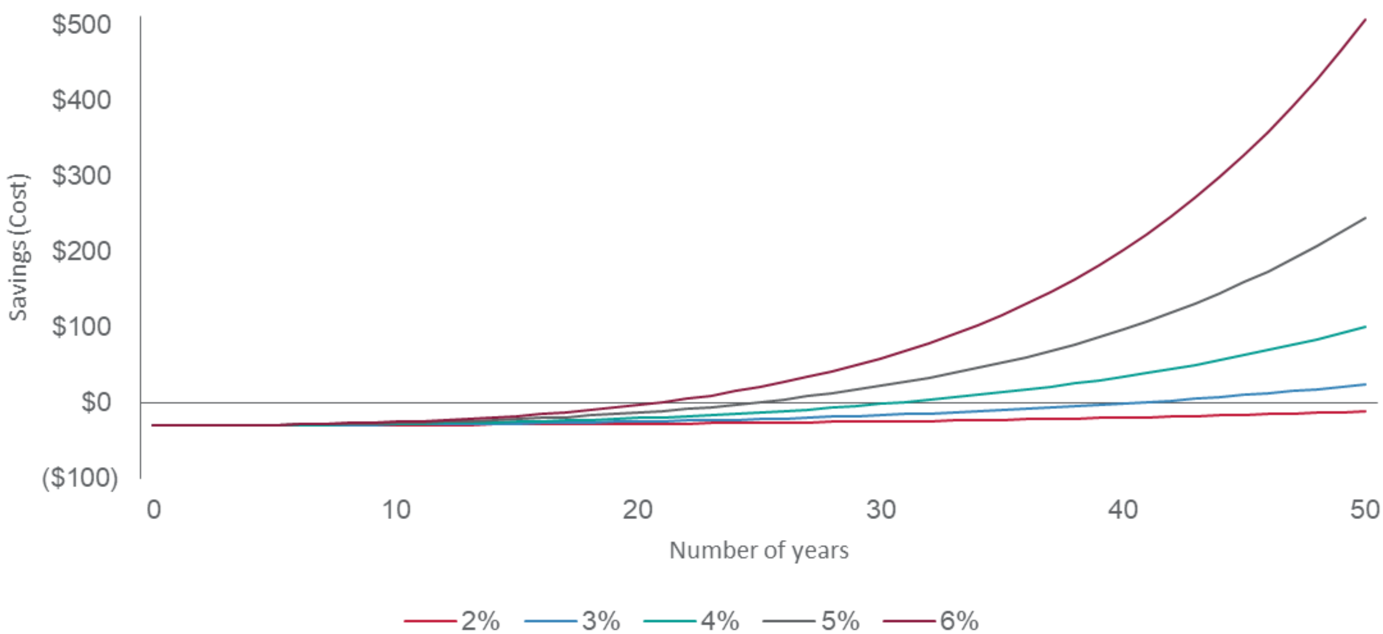
After 25 years, Reza would have the same amount of cash ($23,705) whether she initially paid the $100 fee inside her RRSP or outside her RRSP. In this case, Reza's breakeven point is 25 years.

How rates of return affect the breakeven point

Your future rate of return will have an impact on the breakeven point. With higher rates of return, there are fewer years to the breakeven point because it takes less time for the lost growth to offset the tax savings from paying fees inside an RRSP. The reverse is also true.

Figure 2 shows Reza's savings (cost) over time from paying fees outside an RRSP using the same assumptions as in Figure 1, but at rates of return between 2% and 6%.

Figure 2: Reza's savings (cost) from paying fees outside an RRSP[7]



The breakeven point ranges from 21 years with a 6% rate of return to 40 years with a 3% rate of return. (With a 2% rate of return, the breakeven point is 61 years, which is beyond the range of our graph!) Depending on her rate of return, Reza may need to stay invested in her RRSP for 20, 30, 40 or even more years before she would have any savings from paying her fees outside an RRSP.

How tax rates affect the breakeven point

The tax rate you pay on RRSP withdrawals can affect the breakeven point. The higher your tax rate on withdrawals, the higher the tax savings from paying fees inside the plan, increasing the length of time to the breakeven point.

The type of income that you earn can also affect your tax rates. While all income from an RRSP is fully taxed (upon withdrawal from the plan), this is not always the case for income earned outside registered plans.

Although interest and foreign dividends are fully taxed in non-registered accounts, tax rates are lower for Canadian dividends (which benefit from the dividend tax credit) or capital gains (which are only half taxable).

7 Assuming Reza cashed out her investments at the end of a given year, has a 30% tax rate, and a rate of return of 2%, 3%, 4%, 5% or 6%.

When the tax rate on RRSP withdrawals is higher than the tax rate on income in non-registered accounts, it generally takes longer to reach the breakeven point. And, depending on the difference in tax rates, you may never reach a breakeven point.

This is further complicated by the fact that statutory tax rates can change over time and are affected by the amount of income you earn, due to the progressive nature of our tax rates. As a result, there's no sure way to accurately predict what your tax rate will be when you receive income from non-registered investments or your RRSP, which affects the breakeven point.

So, is there a benefit from paying fees outside an RRSP?

The bottom line is that to have any benefit from paying fees outside an RRSP, you have to stay invested beyond the breakeven point, which can be several decades. Unfortunately, most investors can't predict with any certainty what their rates of return or tax rates will be in the future, so it's nearly impossible to determine what your breakeven point would be. And even if you could, you can't be certain that you'll stay invested long enough to even reach the breakeven point, much less go beyond it and realize that benefit.

Conclusion

No investor wants to get caught up in the advantage rules and face a 100% penalty tax. Fortunately, you're safe to pay investment management fees for your registered plans from your non-registered accounts without having to concern yourself with the advantage rules.

As for whether fees should be paid from inside or out, with TFSAs, it seems pretty clear they should be paid from outside to maximize the tax-free growth from within the plan. For RRSPs and RRIFs, this is not an easy question to answer, as it will depend on your investment time horizon, expected rates of return and tax rates.

While it's impossible to know at the time of you pay fees whether you'll surpass the breakeven point (as illustrated above), the good news is that if you do decide to pay the fees from outside the plan, at least you won't face a 100% penalty tax!

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