Canada

Government Eliminates Foreign Property Restrictions on Retirement Savings Plans

On June 28, 2005, after much tense debate, the 2005 budget received Royal Assent, marking a victory for both the minority Liberal government and the millions of Canadians who invest in tax-exempt pension and retirement savings plans. With the passing of the budget, amendments to the *Income Tax Act* (Canada) (the "Tax Act") came into force that eliminate the restrictions previously placed on the amount of "foreign property" that certain types of Canadian deferred income plans (including pension plans and registered retirement savings plans) ("Deferred Plans") may acquire. Canada was reportedly one of the only industrialised nations that continued to maintain statutory limitations comparable to those previously placed on the foreign holdings of Deferred Plans.[1]

The Tax Act previously stipulated that Deferred Plans were generally required to limit their investments in "foreign property" (which was broadly defined to include many types of foreign-based investments, including shares or debt issued by foreign entities) to 30 percent of the assets held by the respective plan. Deferred Plans that made investments in foreign property that exceeded the statutory threshold were generally subject to a monthly penalty tax equal to 1 percent of the cost amount of the excess holdings. While the applicable statutory threshold was gradually increased over the years from 10 percent to 30 percent of the value of a Deferred Plan's assets, the government's decision to abandon the foreign property limitation entirely reflects a significant shift away from the government's original policy position. The foreign property rules were introduced in 1971 to ostensibly secure a guaranteed source of investment funding for Canadian businesses, lower the cost of capital for Canadian enterprises, and stimulate the domestic economy. The elimination of the foreign property restrictions appears to accept the realities of the global integration of capital markets and the economic inefficiencies that are inherent in widely limiting the investment choices of a significant class of investors.

It remains to be seen whether the elimination of the foreign property restrictions will encourage a flight of investment capital from Canada to the detriment of domestic equity markets. Under the former statutory regime, many Deferred Plans invested in so-called "clone funds", which used derivative instruments to mimic the returns that would otherwise be earned on foreign property without running afoul of the foreign property restrictions. It was estimated that, at the beginning of 2005, there were 350 clone funds operating in Canada with a value of Cdn$27 billion (representing 5 percent of the total funds invested in Canadian mutual funds).[2]

Moreover, a 2002 research paper previously commissioned by the Pension Investment Association of Canada and the Association of Canadian Pension Management suggested that the elimination of the foreign property restriction might actually have a positive impact on Canadian equity markets if the move is perceived as a constructive removal of Canadian capital controls.[3] Nevertheless, regardless of the broader economic implications of the removal of the foreign property restrictions, the new legislative changes will undeniably benefit those Canadians who invest in Deferred Plans.

1 Jonathan Chevreau, "Don't Be Afraid to Boost Your Foreign Content", *The National Post*, April 21, 2005.

2 Jonathan Chevreau and David Berman, "End of Foreign Content Cap Sends Out the Clones", *The National Post*, February 25, 2005

3 David Burgess and Joel Fried, "The Foreign Property Rule: A Cost-Benefit Analysis", (London, Ontario: University of Western Ontario), November 2002.

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