

Does RRSP – Eligible mean RRSP Appropriate?

A Discussion of the Key Considerations in Assessing the Security, Risk and Appropriateness of Private Real Estate Investments for Deferred Income Plans

Introduction

Considered by many to be the single most important tax minimization strategy available to Canadians, Registered Retirement Savings Plans (RRSPs) and other deferred income plans are a cornerstone of modern individual financial planning and investment.

Despite the obvious tax minimization and long-term savings impact of these structures, many Albertans have not experienced the long-term benefits they may have expected and this is due entirely to the failure of their investments, made with cash contributed to their RRSPs, to generate consistent, positive investment returns over extended periods of time.

Largely as a result of low and / or unstable returns from mainstream investment products (like mutual funds), Albertans have increasingly been attracted to real estate investments and private issuers (often builders, developers and entrepreneurs) have responded with a broad range of investment opportunities. Making their investments RRSP eligible allows private issuers to gain access to a large pool of investor funds, effectively broadening the market appeal of their offering which enables them to raise more money, faster.

A significant issue arising from this, and the primary subject of this discussion paper is that in making a private real estate investment through their RRSP, many Albertan's (incorrectly) assume that an investment's RRSP eligibility is an indication that the investment is less risky or provides greater security and is therefore suitable for a retirement or long term savings account.

This paper provides some practical insight to the RRSP investment framework in terms of the Canadian federal laws, RRSP administration and the real estate industry in general. The central purpose is to allow readers to better distinguish between RRSP-eligible, private real estate investments on the basis of their underlying security in order to make more informed personal investment decisions.

RRSPs and other Deferred Income Plans

Although the term RRSP (or RSP) has become part of the public consciousness, it is only one of many deferred income plans, which are sanctioned by the Canadian and provincial governments, that provide Canadians with favourable tax treatment based on their stage of life, education and savings objectives.

Although the scope of this paper does not include a detailed discussion of each, other deferred income plans include Registered Education Savings Plans (RESPs), Registered

Income Funds (RIFs), Locked-In Retirement Accounts (LIRAs), Registered Disability Savings Plans (RDSPs) and as of January 1, 2009, Tax Free Savings Accounts (TFSAs).

For the purposes of this discussion we will refer only to RRSPs and, although many of the concepts covered will be relevant to other deferred income plans, it is suggested that the reader seek clarification and advice from a licensed professional.

RRSP Account Administration – Banks, Credit Unions and Trusts

All RRSP accounts must be held and administered by duly authorized institutions, such as banks, credit unions and trust companies. The policies of these institutions vary widely with regard to the types of investments they will allow their account holders to make.

Many banks offer both managed and self-directed RRSPs and work very hard to convince their account holders to purchase only “bank-authorized” investment products. Most will simply not allow their account holders, even those with self-directed plans, to invest in private real estate investments despite their RRSP-eligibility.

Investors then, wishing to invest in private real estate investment products must find an institution willing to allow these investments and then open an RRSP account with that institution. Many Trust Companies have reacted to this demand by offering self-directed plans for which they will allow private real estate investments on a case-by-case basis.

As part of this process, the Trust Company must decide (either internally or by relying on an independent tax professional) if the offering is RRSP-eligible, but gives no assurances as to its *appropriateness* to account holders who invest. A Trust Company is an *administrator only* and does not provide advisory services to account holders, nor does it have any responsibility for assessing the quality of the issuer (the real estate company) or the security.

Thus, Trust Companies offer only self-directed RRSPs and account holders must rely on their own judgment or seek advice from others as to security and other considerations. Just because a Trust Company approves an investment for RRSP account holders does not mean the Trust Company is endorsing the quality or appropriateness of the security. It merely means the security meets their interpretation of the legal requirements of an RRSP-eligible investment.

Canada Revenue Agency (CRA) Regulations

According to the Canadian Income Tax Act there are several types of investments that are eligible for RRSPs which can be characterized by the types of legal entities that issue them. These include publicly-trade companies (PubCos), Mortgage Investment Corporations (MICs) and Mutual Fund Trusts (MFTs) among others.

Although there are regulations which govern the formation of these entities, once formed the managers of these entities are free to create and distribute private, RRSP-eligible investment products which are not held to any standard or test of security for the investor whatsoever.

Paradoxically, a company that is simply incorporated may also create and distribute private, RRSP-eligible investment products to investors without a prospectus, however such investment products are required, by definition, to be *fully secured*.

It appears that the regulations have been drafted to (indirectly) protect the investor by relying on the assumption that the strict regulations surrounding the formation of PubCos, MICs and MFTs are an acceptable alternative to the requirement of directly testing the security of the private investments that they issue.

Given the range of unscrupulous behaviours we've observed among PubCos in recent years, the reasonability of this assumption could be questioned and one may conclude that these regulations may not be an adequate indication that the securities PubCos issue are fully (or even partially) secured.

What is “Fully Secured”?

In 2006, the Canada Revenue Agency revised its guidelines for private companies issuing real estate backed securities for investment to require that any such securities be *fully secured*. The words are somewhat ambiguous, however a sensible person familiar with current practices up to that point would recognize the change was designed to curb the incidences where a private company was issuing securities (e.g. mortgage debt) against a property that was worth less than the value of the security.

An example would be that a company purchased a piece of land worth \$7.5 million dollars and soon after raises \$16 million from private investors based on a pledge of the land as security for the investment. Common sense would suggest the investors are not fully secured.

For the many private companies in operation then, as now, with sufficient integrity not to raise more money than the property used as security was worth, this should not have been a problem. However a technical consideration gave rise to the question of whether even conservative real estate companies could meet the test from a practical standpoint.

Consider that a typical real estate development process would include the purchase of a piece of land followed by the construction of something on it. Typically construction financing is provided by a bank or institutional lender who, at the beginning of the process, would register the full amount of the construction financing on title to the property in anticipation of making successive (usually monthly) advances to the developer as the construction progressed to completion.

Suppose that a real estate developer purchases a piece of property for \$10 million with the intent of building a \$40 million building on it. The company raises \$5 million from private investors to help pay for the land and obtains construction financing from a bank for the \$40 million construction cost. At the outset of construction, assuming both the private investment and the construction financing are registered on title, there is a total of \$45 million of claims against a property worth only \$10 million. Given that the private investors' claim is invariably behind that of the banks, can they be considered fully secured?

The answer to the question depends on one's view of the \$40 million claim. Since it is registered in anticipation of \$40 million of construction advances but no advances have yet taken place, one might conclude that the net effect of the claim is \$0 and the only real claim is for the investors' \$5 million.

One might further assert that if the bank advanced \$10 million of the construction financing, the resulting work in place would simultaneously raise the value of the land. In other words, with \$10 million advanced by the bank, the total claims would then be \$15 million, but the value of the land would now have increased to \$20 million, maintaining (and usually improving) the security for both the bank and the investors. Certainly it is reasonable to assert that the construction of the project improves the value of the land by more than the cost. If it did not, there would be no incentive to construct the project in the first place!

The opposing view is that the strictest interpretation of the guidelines concludes that, at the beginning of the project there is \$45 million of claims against a property worth only \$10 million dollars. Although such a strict interpretation would likely not argue the improving value of the lands throughout the course of the project, technically it would preclude any real estate company from employing conventional construction financing and simultaneously meeting the test of full security.

Penalties for “Negative Eligibility”

If the Canada Revenue Agency were to decide that an investment did not qualify as RRSP-eligible sometime after the investment was made using funds from an RRSP account, the investor could be subject to financial penalties of as much as *1% per month since the investment was first made* or up to 12% per year. In addition, the investor would be required to replace the funds in their RRSP account or claim the amount as a cash withdrawal which would then be fully taxable.

In either case, the investor could find themselves facing stiff penalties and a significant cash flow problem if the funds which they invested were not readily available to meet the combination of penalties, re-contribution and /or tax.

Given the penalties involved if the Canada Revenue Agency were to rule against the RRSP-eligibility of an investment, many Trust Companies have adopted the strictest interpretation of the guidelines. The result is that investments by private real estate

companies that may reasonably be considered fully secured may not be considered RRSP-eligible yet, somewhat ironically, PubCos, MICs & MFTs which are not held to any test of full security as a condition of their eligibility *are* considered eligible.

It follows then, that an investment that is issued by a private company that has been independently validated as RRSP-eligible AND subsequently approved by a Trust Company for its self-directed plans has *inherently better security characteristics* because it directly meets the Canada Revenue Agency's requirements for RRSP-eligibility INCLUDING a reasonable test of "full security"!

Conclusions – What to Watch For...

Many private real estate companies cannot meet the regulations required to establish the entities (PubCo, MIC, MFT) which the Canadian Income Tax Act authorizes to produce and distribute RRSP-eligible investments. Their alternatives then, are to issue securities which are fully secured (and find a Trust Company to authorize it for their RRSP account holders) or to partner with established entities which are authorized to issue RRSP-eligible securities.

In considering the first alternative, we revisit the company that purchased a \$10 million property and issues \$5 million of securities to investors. If one concludes that from a reasonable standpoint, this situation represents full security for the investor, it remains that the real estate company has \$5 million of its own money to make up the difference. This is an excellent indication of security for the investor since any real estate company that raises money from investors against a property in which they have not invested real cash themselves would likely be unable to claim that the investors are fully secured.

Investors should carefully examine the current appraised value of the property AS IS (less any other claims or indebtedness) and compare this value to the amount of money the company is seeking to raise from private investors. If the land is worth less, the investment cannot be considered fully secured.

If the private real estate company is unable to make their offering RRSP-eligible on the basis of it being a fully secured investment, their only alternative is to find a qualifying entity (e.g. a PubCo) through which to issue their investment. The private real estate company will not attach the underlying property to the investment so as not to give up control of the asset to the PubCo. Although this may appear to be insignificant, in point of fact is very important to the investors. The result is there is no legal connection between the investment and the real estate asset, so investors have NO TANGIBLE SECURITY WHATSOEVER!

Investors should carefully examine the relationship between their investment, the company issuing the investment and the ownership of the property they believe they are investing in. If the investment is not secured directly by the property that is represented as security for the investment, either through registration directly on title or through a

single entity which both owns the asset and issues the investment, the investors' security for their investment has likely been compromised.

A private investment offering is typically communicated through a detailed offering document called an Offering Memorandum. Usually such an offering does not directly indicate the Tax Act Regulation under which the investment offering is deemed to qualify for RRSP-eligibility. The form of the Offering Memorandum should, however, include a Tax Consequences section indicating that an independent review has been performed by a Chartered Accountant.

Investors should be alerted to the absence of a Tax Consequences section in any Offering Memorandum they are reviewing as an indication the offering was improperly prepared and may not, in fact, have any legitimate basis for RRSP-eligibility. Investors should request a copy of the written opinion from the independent Chartered Accountant attesting to the basis of the offering's qualification as an RRSP-eligible investment or contact the Chartered Accountant directly in the alternative.

Private real estate investments, whether RRSP-Eligible or not, are not required to be vetted by securities regulators and offered through a prospectus. The Alberta and British Columbia Securities Acts, like many other provincial securities laws, allow for the offering of private real estate investments without a prospectus (prospectus-exempt) and are usually described in an Offering Memorandum. In exchange for the prospectus exemption, issuers are restricted to selling the investment only to investors who acknowledge in writing that they understand the risks involved in the investment (Risk Acknowledgement) and that they are sophisticated enough (as demonstrated by their income, net worth, relationship with the issuer, etc.) to make an informed, independent investment decision (Investor Eligibility).

Investors should carefully examine the form and content of any Offering Memorandum they are considering for investment and seek independent advice regarding the offering prior to making an investment decision.

Should you have further questions or comments regarding the contents of the foregoing, please direct them to Jonathan K. Allen, Vice President Investments – Unity Investments Inc. at jonathana@unityinvestments.com or (403) 730-9364.