Personal Tax Planning

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Registered Savings Plans:
Investing Without Penalty

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This article provides an update on the types of investments permitted for registered savings plans, taking into account the recent introduction of tougher anti-avoidance rules and penalties for registered retirement savings plans, registered retirement income funds, and tax-free savings accounts. Registered disability savings plans also are discussed.

Keywords: Registered Retirement Savings Plan ■ Registered Retirement Income Fund ■ Tax-Free Savings Account ■ Registered Disability Savings Plan ■ Anti-Avoidance ■ Penalties

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INTRODUCTION

Over the years, Canada has introduced a range of registered savings plans, to encourage individuals to save for retirement, education, the long-term financial security of a disabled family member, and other personal financial goals. These plans include registered retirement savings plans (RRSPs), registered retirement income funds (RRIFs), registered education savings plans (RESPs), registered disability savings plans (RDSPs), and tax-free savings accounts (TFSAs).

From time to time, in order to promote the use of registered savings plans and make them more attractive, the government has expanded the types of qualified investments permitted under the Income Tax Act¹ and has enhanced the tax attributes

¹ RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.
of particular plans. Other measures have been introduced to combat a growing concern over the perceived abuse of such plans to obtain unintended tax benefits. For example, the government announced tighter anti-avoidance rules for TFSAs in October 2009 and for RRSPs and RRIFs in March 2011.

This article provides an update on qualified investments for registered savings plans, and discusses how the rules differ among the various plans. In addition, the article reviews the various penalty taxes that may apply to discourage inappropriate investments and transactions—the non-qualified investment rules, prohibited investment rules, and advantage tax rules. The impact of these rules on certain commonly held investments is also discussed. Finally, the article reviews various transitional and other relieving measures available to individuals who find themselves offside the rules.

The discussion of the penalty rules for TFSAs, RRSPs, and RRIFs under part XI.01 of the Act takes into account, as if it were law, the draft legislation of December 2012. The impact of these proposed amendments is highlighted where applicable.

QUALIFIED INVESTMENTS

The starting point for determining whether an investment may be held in a registered savings plan is the definition of “qualified investment” for the particular type of plan. There are subtle differences among the definitions, but they all share the same three basic components: specific inclusions by reference to qualified investments for deferred profit-sharing plans (DPSPs), the specific inclusion of certain annuity contracts, and the listing of prescribed investments. The types of investments included in each category are briefly described below.

**Qualified Investments for DPSPs**

The following types of investments are qualified for all plans by virtue of being qualified for DPSPs:

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2 Examples include the introduction of the RRSP home buyers’ plan and lifelong learning plan; elimination of the seven-year limit on the carryforward of unused RRSP deduction room; an increase in the contribution limits for RESPs and RRSPs; the introduction of rollovers between various plans; the introduction of Canada savings grants and bonds for RESPs and similar grants and bonds for RDSPs; and the introduction of various improvements to RDSPs in the 2011 and 2012 federal budgets.

3 Canada, Department of Finance, *Legislative Proposals Relating to Income Tax* (Ottawa: Department of Finance, December 21, 2012) (herein referred to as “the December 2012 draft legislation”). References in this article to “proposed” sections or regulations are to provisions contained in this draft legislation.

4 Definitions of “qualified investment” are found in subsections 146(1), 146.1(1), 146.3(1), 205(1), and 207.01(1), applicable to the respective plans covered by those provisions.

5 Section 204, the definition of “qualified investment.”
money, deposits, and guaranteed investment certificates;
government bonds and investment-grade debt;
debt obligations of certain entities listed on a “designated stock exchange”6 in Canada or a foreign country;
debt obligations issued by an authorized foreign bank and payable at a branch in Canada of the bank; and
securities (other than futures contracts or other derivative instruments in respect of which the holder’s risk of loss may exceed the holder’s cost) that are listed on a designated stock exchange.

**Annuity Contracts**

All plans may generally hold various accumulation annuities and segregated fund policies. In addition, RRSPs, RRIFs, and RDSPs may invest in certain other annuities that meet specified conditions.7

**Prescribed Investments**

The following types of investments are prescribed for all plans:8

- an interest in a trust or a share of the capital stock of a corporation that was a registered investment for the plan trust;9
- a share of the capital stock of a public corporation, including certain mortgage investment corporations;
- a bond, debenture, note, or similar obligation of various types of corporations;
- a unit of a mutual fund trust;
- an option, warrant, or similar right issued by a person or partnership that gives the holder the right to acquire property that is a qualified investment, or to receive a cash settlement in lieu of that property, where that property is a share of the capital stock of, unit of, or debt issued by, the issuer and the issuer is not a connected person;
- a debt obligation that is fully secured by a mortgage or similar instrument in respect of real property situated in Canada where the debtor is not a connected person;

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6 As defined in subsection 248(1).
7 See supra note 4.
8 Regulation 4900.
9 A “registered investment” as defined in subsection 204.4(1) generally includes various pooled investment vehicles marketed as investments for tax-deferred plans and specifically approved by the minister of finance. A list is published in the *Canada Gazette* and may be found at www.gazette.gc.ca. See also regulation 4900(5).
- a debt obligation secured by a mortgage where the debt obligation is administered by an approved lender under the National Housing Act and insured under the National Housing Act;
- a gold or silver legal tender bullion coin or bullion bar; and
- a share of the capital stock of certain eligible or small business corporations, a limited partner interest in a small business investment limited partnership, and an interest in a small business investment trust.10

This list has evolved over time and now includes various forms of foreign investment that were previously restricted. More recently, the introduction of the prohibited investment rules makes it significantly more difficult for private company shares to be considered qualified investments. (See “Private Company Shares” below for further discussion.)

**ANTI-AVOIDANCE PENALTIES**

The Act includes a number of penalty taxes and other anti-avoidance rules aimed at preventing possible abuses involving registered plans, such as inappropriate investments and transactions.11 The following discussion focuses on the non-qualified investment rules, the prohibited investment rules, and the advantage tax rules.

**TFSAs, RRSPs, and RRIFs**

Shortly after the original TFSA provisions came into effect, the government introduced tighter penalties and anti-avoidance rules.12 The enhanced anti-avoidance rules, applicable after October 16, 2009, target deliberate overcontributions and asset transfer transactions (“swaps”) intended to shift value from one registered account to another, and prevent the tax-sheltered growth of investment income attributable to deliberate overcontributions, prohibited investments, and non-qualified investments.13

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10 The rules applicable to small business investments vary among the particular plans: see regulations 4900(6) through (14) and proposed regulation 4900(15).

11 For example, part X.1 tax for overcontributions to an RRSP, part X.4 tax for overpayments to an RESP, and section 207.02 tax for excess TFSA amounts; section 207.03 tax for non-resident contributions to a TFSA; penalties for using registered property as security under section 206.3 and subsections 146(10) and 146.3(7); and part X.5 tax on accumulated income payments from an RESP.


13 As defined in subsection 207.01(1).
The government was also concerned about a growing number of aggressive tax-planning schemes involving RRSPs and RRIFs, including, for example, RRSP strips (arrangements designed to access RRSP funds on a tax-free basis). As a result, the 2011 federal budget extended the enhanced TFSA anti-avoidance rules to RRSPs and RRIFs (with some modifications as appropriate).

**RESPs and RDSPs**

There is less opportunity for abusive tax planning involving RESP and RDSP. These plans are designed for very specific purposes, and the conditions for registration ensure that the holders (or subscribers) and issuers adhere to those purposes. For example, an RDSP can only be opened for the benefit of an individual who is eligible for the disability tax credit (DTC). In the case of RESP, an additional 20 percent tax on amounts withdrawn as accumulated income payments discourages the use of these plans for unintended purposes.

For these reasons, the anti-avoidance rules for RESP and RDSP are not as extensive as those introduced for RRSP and RRIF, and TFSA. Nonetheless, RESP and RDSP are subject to penalties for holding non-qualified investments, and RDSP are also subject to penalty taxes on certain advantages and transactions involving inadequate consideration.

**NON-QUALIFIED INVESTMENTS**

Adverse tax consequences arise when a registered plan acquires or holds an investment that is a non-qualified investment.

**RESP**

An RESP trust is liable for a 1 percent penalty tax in respect of any month in which the trust holds property that is a non-qualified investment at the end of the month. The 1 percent tax is based on the fair market value (FMV) of the non-qualified investment at the time it was acquired. In addition, if an RESP trust acquires a non-qualified investment, or holds a property that ceases to be a qualified investment and is not

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14 See Canada Revenue Agency (CRA), Compliance Bulletin no. 6r1, December 2012 and Compliance Bulletin no. 4, June 2007, as well as the CRA’s Tax Alert notices released on November 29, 2007 and March 17, 2009.

15 Canada, Department of Finance, 2011 Budget, March 22, 2011.

16 Subsection 146.4(1), the definition of “DTC-eligible individual,” and paragraph 146.4(4)(f).

17 Subsection 204.94(2). Accumulated income payments are generally amounts not used as education assistance payments and not eligible for rollover to another registered plan.

18 Subsection 207.1(3).
disposed of within 60 days of becoming a non-qualified investment, the plan may be revoked by the minister of national revenue.\textsuperscript{19} If the plan registration is revoked, the trust becomes taxable as an inter vivos trust.\textsuperscript{20}

**RDSPs, RRSPs, RRIFs, and TFSAs**

The holder of a TFSA or the annuitant of an RRSP or RRIF must pay a penalty tax for each calendar year in which the trust has acquired a non-qualified investment, or in which a property held by the trust becomes a non-qualified investment. The tax is equal to 50 percent of the FMV of the non-qualified investment at the time the property was acquired or became a non-qualified investment.\textsuperscript{21} A similar penalty tax applies to an RDSP trust when a non-qualified investment is acquired or a property held by the trust becomes a non-qualified investment.\textsuperscript{22} This tax may be refunded or waived in certain circumstances. (See the discussion below under “Transitional and Other Relieving Measures.”)

In addition, a TFSA, RRSP, RRF, or RDSP must pay part I income tax (at rates applicable to an inter vivos trust) on any income earned from a non-qualified investment held in the year. Income from a non-qualified investment includes capital dividends and the full amount of capital gains in excess of capital losses.\textsuperscript{23} Unlike RESPs, these plans are not required to dispose of the investment within 60 days.

For RRSPs and RRIFs, the 50 percent tax on non-qualified investments replaces the former income inclusion and deduction for the annuitant, as well as a 1 percent per month penalty tax for the trust.\textsuperscript{24} The current rules apply to non-qualified investments acquired by an RRSP or RRIF after March 22, 2011, and to investments acquired before March 23, 2011 that first became non-qualified investments after March 22, 2011. In the case of TFSA, the rules apply after 2008.

**PROHIBITED INVESTMENTS**

The prohibited investment rules apply only to RRSPs, RRIFs, and TFSA, and are intended to

\textsuperscript{19} Subsections 146.1(2.1) and (12.1). See regulation 4900(13) for circumstances in which a qualified investment may become non-qualified.

\textsuperscript{20} Subsection 146.1(11).

\textsuperscript{21} Subsections 207.04(1) and (2).

\textsuperscript{22} Section 206.1.

\textsuperscript{23} Subsections 146(10.1), 146.2(6), 146.3(9), and 146.4(5), applicable, respectively, to RRSPs, TFSA, RRIFs, and RDSPs.

\textsuperscript{24} An annuitant of an RRSP or RRIF was required to include in income the FMV of a non-qualified investment acquired by the RRSP or RRIF under former subsections 146(10) and 146.3(7), and was allowed an offsetting deduction when the investment was disposed of under former subsections 146(6) and 146.3(8). The 1 percent per month penalty tax was imposed on the trust under former subsections 207.1(1) and (4).
prevent the acquisition by an individual’s registered plan of closely-held investments . . . , or investments that carry a significant risk of being designed with a view to streaming disproportionate returns into a registered plan (effectively circumventing contribution limits) or that facilitate an intentional de-valuation of the investment (in order to avoid a later income inclusion). 25

It is important to recognize that even if an investment is a qualified investment, it may nonetheless be considered a prohibited investment.

**Penalty Tax on Prohibited Investments**

The penalty tax is the same as the tax for non-qualified investments. For TFSAs, RRSPs, and RRIFs, the annual tax is equal to 50 percent of the FMV of the prohibited investment at the time the property was acquired by the trust or became a prohibited investment for the trust. 26 This tax may be refunded or waived in certain circumstances. (See the discussion below under “Transitional and Other Relieving Measures.”)

For RRSPs and RRIFs, the penalty tax applies to prohibited investments acquired after March 22, 2011 and to investments acquired before March 23, 2011 that first became prohibited investments after October 4, 2011. 27 An exception is provided for transfers between RRSPs or RRIFs of the same annuitant if the investment was a prohibited investment of the transferring RRSP or RRIF on March 23, 2011. 28 In the case of TFSAs, the rules apply after 2008.

The holder or annuitant may also be subject to a 100 percent advantage tax on any income and realized capital gains reasonably attributable to a prohibited investment in the plan. (See the discussion below under “Advantage Tax Rules.”)

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25 Canada, Department of Finance, “Part XI.01 Registered Retirement Savings Plan and Registered Retirement Income Fund Measures,” comfort letter issued to the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants, June 12, 2012.

26 Subsections 207.04(1) and (2).

27 In Canada, Department of Finance, “Part XI.01 Taxes—Expansion of the Transitional Relief for Certain Prohibited Investments Held by an Individual’s RRIF or RRSP,” comfort letter issued February 12, 2013, the Department of Finance indicated that it will recommend that grandfathered property status be preserved for the purposes of the prohibited investment and advantage tax rules where an RRSP or RRIF acquires new shares on a share-for-share exchange involving grandfathered property in the course of certain corporate reorganizations (such as butterflies), provided that no non-share consideration is included in the transaction and the exchange occurs on an FMV basis.

28 Coming-into-force provision of subsection 207.04(1).
**WHAT IS A PROHIBITED INVESTMENT?**

A prohibited investment may generally be described as an investment to which the holder of a TFSA or the annuitant of an RRSP or RRIF is closely connected, including the following:\(^{29}\)

- a debt of the holder or annuitant;
- a debt or equity investment in a corporation, trust, or partnership in which the holder or annuitant has a significant interest;\(^{30}\)
- a debt or equity investment in a corporation, trust, or partnership with which the holder or annuitant does not deal at arm’s length;
- an interest in, or right to acquire, any of the investments described above; and
- a share that ceased to be a qualifying share of a specified small business corporation, a venture capital corporation, or a specified cooperative corporation, at any time after the share was acquired.

The following are specifically excluded from prohibited investments (beginning after March 22, 2011):\(^{31}\)

- certain insured mortgages (and similar instruments);
- certain equity investments in regulated mutual funds, or registered investments that follow an investment diversification policy, if the mutual fund or registered investment entity is in its 24-month startup phase or 24-month windup phase; and
- certain equity investments that satisfy a seven-part test and as a result can be viewed as arm’s-length portfolio investments.

For the purposes of the third exclusion, the seven-part test examines the closeness of the relationship between the holder or annuitant of the registered plan and the issuer of the investment to determine whether the holder or annuitant is in a position to manipulate the value of the investment or the distribution of income. The seven-part test requires that all of the following conditions be met:\(^{32}\)

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29 See the definition of “prohibited investment” in proposed subsection 207.01(1), and proposed regulation 4900(15), replacing existing regulation 5001.

30 Subsection 207.01(4) and subsection 248(1), the definition of “specified shareholder.” An individual holds a significant interest in a corporation if that individual owns, alone or together with non-arm’s-length persons, 10 percent or more of the issued shares of any class of the capital stock of the corporation.

31 The definition of “excluded property” in proposed subsection 207.01(1), replacing existing regulation 5000. Prior to March 23, 2011, the only exclusions provided in regulation 5000 included certain insured mortgages (and similar instruments) and certain investments in regulated mutual funds during the 24-month startup phase of the fund.

32 Paragraph (c) of the definition of “excluded property” in proposed subsection 207.01(1).
Arm’s-length individuals hold at least 90 percent of the FMV of all equity of the issuer.

Arm’s-length individuals hold at least 90 percent of the total FMV of all equity and debt of the issuer.

Arm’s-length individuals hold at least 90 percent of the votes that can be cast at an annual meeting of the issuer.

The terms and conditions of each share or unit held by the registered plan are the same as, or similar to, the terms and conditions of the equity held by arm’s-length individuals (arm’s-length equity).

The FMV of the arm’s-length equity with the same (or similar) terms and conditions is equal to at least 10 percent of the total FMV of all equity of the issuer with the same (or similar) terms and conditions.

The holder or annuitant deals at arm’s length with the issuer.

None of the main purposes of the structure of the issuer, or the terms or conditions of the equity, is to accommodate transactions or events that could affect the FMV of the investment held by the registered plan in a manner that would not occur in a normal commercial or investment context in which parties deal with each other at arm’s length and act prudently, knowledgeably, and willingly.

This exclusion may apply, for example, where an individual and his or her close family members own more than 10 percent of a single class of shares of a large arm’s-length mutual fund corporation with multiple classes of shares representing different funds, and the equity interest is very small relative to the capitalization of the corporation as a whole.

The implications of the prohibited investment rules for certain commonly held investments are discussed further below under “Impact of Tighter Penalty Rules on Specific Investments.”

ADVANTAGE TAX RULES

A penalty tax also applies to certain “advantages” obtained from transactions intended to exploit the tax attributes of TFSAs, RRSPs, RRIFs, or RDSPs. The advantage tax rules do not apply to RESPs.

Penalty Tax on Advantages

The advantage tax is equal to 100 percent of the FMV of the benefit obtained, or in the case of a loan or indebtedness, the amount of the loan or indebtedness. Similarly,

33 As defined in proposed subsection 207.01(1) in respect of TFSAs, RRSPs, and RRIFs, and in subsection 205(1) in respect of RDSPs.

34 Section 206.2 for RDSPs and section 207.05 for TFSAs, RRSPs, and RRIFs.
in the case of an RRSP strip\(^{35}\) (discussed below), the amount of the tax is equal to the amount of the RRSP strip.\(^{36}\)

The tax is payable by the annuitant or holder of the registered plan, except that if the advantage is extended by the issuer of the registered plan or by a person not dealing at arm’s length with the issuer, the issuer is liable for the tax. In certain circumstances, this tax may be waived. (See the discussion below under “Transitional and Other Relieving Measures.”)

For RRSPs, the new advantage tax rules replace the former penalty on the issuer equal to the greater of $100 and the value of the advantage.\(^{37}\) The advantage tax applies to both RRSPs and RRIFs in respect of transactions occurring, income earned, capital gains accruing, and investments acquired after March 22, 2011.\(^{38}\)

In the case of RDSPs and TFSA, the 100 percent advantage tax generally applies from the time those plans became effective (that is, for taxation years after 2007 in the case of RDSP and for taxation years after 2008 in the case of TFSA). However, the expanded TFSA advantage tax rules that target deliberate overcontributions, swap transactions, and second-generation income attributable to deliberate overcontributions, prohibited investments, and non-qualified investments apply after October 16, 2009.

**What Is an Advantage?**

An advantage is broadly defined to include any benefit, loan, or indebtedness that depends on the existence of the registered plan, subject to certain specified exceptions and inclusions. Owing to variations in the rules, it is necessary to review the specific exceptions and inclusions for TFSA, RRSP, and RRIF separately from those applicable to RDSP.

**RDSPs**

An advantage in relation to an RDSP\(^{39}\) means any benefit or loan that is conditional on the existence of an RDSP, other than

- a disability assistance payment;
- a contribution made or authorized by the holder of the RDSP;
- an eligible transfer from one RDSP to another for the same beneficiary;
- a Canada disability savings grant or bond, or a payment under a designated provincial program;

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\(^{35}\) As defined in proposed subsection 207.01(1).

\(^{36}\) Paragraph 207.05(2)(c).

\(^{37}\) Repealed subsection 146(13.1).

\(^{38}\) Proposed subsection 207.01(7), and CRA document no. 2011-0418161E5, February 3, 2012.

\(^{39}\) Defined in subsection 205(1).
a benefit derived from the provision of administrative or investment services for the plan; or

an RDSP contribution loan made in the ordinary course of the lender’s business (with reasonable repayment terms).

For the purposes of determining whether there is an advantage, a benefit includes any payment or allocation of an amount to an RDSP that is represented to be a return on investment in respect of property held within the plan, but that cannot reasonably be considered to be on open market (arm’s-length) terms and conditions.40

**TFSAs, RRSPs, and RRIFs**

An advantage in relation to a TFSA, RRSP, or RRIF generally means any benefit, loan, or indebtedness that depends on the existence of the plan, other than

- a benefit derived from the provision of administrative or investment services for the plan;
- an arm’s-length loan;
- a plan distribution to the holder or annuitant;
- a payment or allocation made directly to the plan by the issuer or carrier; and
- a benefit provided under a widely offered incentive program by the plan issuer (or a person related to the plan issuer), provided that none of the main purposes is to allow the holder or annuitant to benefit from a part I tax exemption.

The last exclusion noted above, added by the December 2012 draft legislation, permits financial institutions to use promotional incentives (such as fee rebates and cash bonuses) to sell their products.

An advantage also specifically includes a benefit that is an increase in the FMV of property held in connection with a registered plan where the increase is attributable to42

- a transaction or event that would not have occurred in a normal commercial or investment context between arm’s-length parties, where one of the main purposes of the transaction or event was to provide an exemption from part I tax on an amount in respect of the registered plan—for example, the issuance of common shares for nominal consideration to a TFSA or RRSP of a key employee as part of an estate freeze transaction;43

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40 Subsection 205(1), the definition of “benefit.”
41 Paragraph (a) of the definition of “advantage” in proposed subsection 207.01(1).
42 Paragraph (b) of the definition of “advantage” in proposed subsection 207.01(1).
• a payment for services (or a payment received on account or in lieu of, or in satisfaction of, such a payment) provided by the holder or annuitant of the plan, or by a person who does not deal at arm’s length with the holder or annuitant (for example, a discretionary dividend paid in lieu of salary to key employees of a private company where the private company shares are held within a registered plan);

• a payment of a return on investment (including interest, dividends, rent, or royalties), or proceeds of disposition, for property held outside the plan by the holder or annuitant, or by a non-arm’s-length person (for example, a return on an investment held within a registered plan that is tied to a second type of investment held outside the plan, where the return on each component of the investment is designed to shift income into the plan);\(^4^4\)

• a swap transaction (discussed below); and

• specified non-qualified investment income (essentially second-generation income) that has not been paid out of the plan within 90 days of receiving a notice from the Canada Revenue Agency (CRA) requiring that the amount be withdrawn.\(^4^5\)

An advantage also includes income, or a capital gain, attributable to\(^4^6\)

• a prohibited investment;

• in the case of a TFSA, a deliberate overcontribution to the plan;\(^4^7\) or

• in the case of an RRSP or RRIF, certain amounts received by the annuitant (or a non-arm’s-length person) that would not have been paid if it were not for property held in the plan, where the amount was a payment for services provided by the annuitant (or a non-arm’s-length person), a return on investment (including interest, dividends, rent, or royalties), or proceeds of disposition (for example, a return on an investment or proceeds of disposition for an investment held outside a registered plan that is tied to a second type of investment held inside the plan, where the return on each component of the investment is designed to shift income out of the plan in order to benefit from preferential tax treatment that is not available within the plan, such as that applicable to dividends and capital gains).\(^4^8\)

\(^{44}\) For an example involving real estate transactions, see Amanjit Lidder, “Current Issues Forum,” in 2011 British Columbia Tax Conference (Toronto: Canadian Tax Foundation, 2011), 1A:1-25, at 1A:5.

\(^{45}\) The definition of “specified non-qualified investment income” in proposed subsection 207.01(1), and subsection 207.06(4).

\(^{46}\) Paragraph (c) of the definition of “advantage” in proposed subsection 207.01(1).

\(^{47}\) As defined in subsection 207.01(1).

\(^{48}\) See supra note 44.
Finally, an advantage includes an RRSP strip in respect of the plan (as discussed below), and a “prescribed benefit.”\textsuperscript{49} There are currently no prescribed benefits under the regulations.

Given the broad list of advantages, individuals will need to closely monitor the administration of their registered plans to ensure that they do not inadvertently become subject to the advantage tax rules.

**Transactions Subject to the Advantage Tax Rules**

Certain transactions undertaken in connection with a TFSA, RRSP, or RRIF will result in the application of the advantage tax rules. A penalty tax may also apply to transactions undertaken in connection with an RDSP for inadequate consideration. The following discussion examines the types of transactions that the penalty rules are aimed at preventing.

**Swap Transactions**

Swap transactions (generally, purchase and sale transactions between accounts) can shift value out of or into a registered plan while avoiding the income inclusions on withdrawal or the limits on contributions (see example 1 below). The rules applicable to such transactions are intended to prevent the exploitation of fluctuations in the market price of securities as a means of shifting value to or from a registered plan, and avoiding tax on any increase in such value.

Generally, a swap transaction refers to a transfer of property between an RRSP, RRIF, or TFSA and the holder or annuitant of the plan (or a non-arm’s-length person). However, the definition of “swap transaction” specifically excludes the following transactions:\textsuperscript{50}

- a distribution in satisfaction of the holder’s or annuitant’s interest (which may occur on a change from one plan issuer to another);
- a payment into the plan that is a contribution, premium, or permitted transfer to a RRIF (such as a transfer of funds from a registered pension plan to a RRIF);\textsuperscript{51}
- a transfer of a prohibited investment or a non-qualified investment out of the plan for consideration in circumstances where the annuitant or holder is entitled to a refund of the penalty tax (see the discussion below under “Refund of Penalty Tax”);\textsuperscript{52}

\textsuperscript{49} Paragraphs (d) and (e) of the definition of “advantage” in subsection 207.01(1).

\textsuperscript{50} The definition of “swap transaction” in proposed subsection 207.01(1).

\textsuperscript{51} The permitted transfers are provided for in paragraph 146.3(2)(f).

\textsuperscript{52} The December 2012 draft legislation clarifies that the consideration paid to the registered plan on the swapout of a non-qualified or prohibited investment is also exempt from the advantage tax rules.
- a transfer of property between an annuitant’s registered plans that are both RRSPs or RRIFs, or a transfer of property between two TFSAs of the same holder.

With respect to the last item, transfers between a TFSA and an RRSP or RRIF of the same individual do not fall within the exception and are considered swap transactions.

Increases in the FMV of a registered plan that are in any way attributable (directly or indirectly) to a swap transaction are considered an advantage. This includes all future increases in the FMV of the registered plan that are reasonably attributable to the initial swap transaction. The CRA has indicated that this includes any dividends, interest, or other amounts paid on the swapped security, any appreciation in the value of the swapped security or a substituted property, and any second-generation income.53

The advantage tax applies to swap transactions involving a TFSA after October 16, 2009; in the case of RRSPs and RRIFs, swap transactions occurring after June 2011 are generally subject to the advantage tax rules. However, a transitional rule permits a swap transaction to be undertaken before 2022 to remove any property from a RRIF or RRSP that would, if retained in the plan, result in part XI.01 tax. (See the discussion below under “Transitional and Other Relieving Measures.”)

**RRSP Strips**

The rules related to RRSP strips are intended to target transactions, such as certain swap transactions, that extract amounts from an RRSP or RRIF on a tax-free basis. However, the definition in the Act as originally drafted included any amount obtained by the annuitant as a result of a transaction or series of transactions one of the main purposes of which was to enable the annuitant (or a non-arm’s-length person) to obtain a benefit in respect of property held by the RRSP or RRIF (subject to certain specified exceptions). The definition was not restricted to decreases in the FMV of RRSP or RRIF property.

In response to concerns raised over the broad meaning, the December 2012 draft legislation clarifies that an RRSP strip occurs only where there is a reduction in the FMV of property held by an RRSP or RRIF as a result of a transaction or series of transactions one of the main purposes of which was to enable the annuitant (or a non-arm’s-length person) to obtain a benefit as a result of the reduction. Under the amended definition,54 an RRSP strip does not include the following:

- an amount included in the income of the annuitant or the annuitant’s spouse or common-law partner;

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54 Proposed subsection 207.01(1), the definition of “RRSP strip.”
an amount withdrawn under the home buyers’ plan or the lifelong learning plan;
- certain permitted transfers between RRSPs and RRIFs; or
- the principal amount of a debt obligation that is “excluded property” (generally defined to mean insured mortgages and similar instruments).\(^{55}\)

If property is removed from an RRSP or RRIF by way of a sale to the annuitant of the RRSP or RRIF for consideration that is less than the FMV of the property, the transaction will be considered to be an RRSP strip,\(^{56}\) and the difference between the FMV of the property and the consideration will be considered to be an advantage, unless the amount is otherwise included in the annuitant’s income.\(^{57}\)

The following example illustrates a swap transaction and an RRSP strip that these rules are intended to prevent.

\textit{Example 1}

Sarah is close to retirement and has $150,000 in her RRSP and $10,000 in her TFSA at the end of the prior year. In the current year, she contributes $5,000 to her TFSA and uses the funds to acquire 500 common shares of Pubco for $10 a share. A few months later, the price of one Pubco share increases to $13, and Sarah transfers the 500 shares in her TFSA for $6,500 cash from her RRSP. There is nothing offensive about this transaction since there is no change in the FMV of either the TFSA or the RRSP.

Now assume that a few weeks later, the price of the shares goes back down to $10, and Sarah transfers the shares back to her TFSA for $5,000 cash. Her TFSA now has an FMV of $16,500 ($10,000 + $5,000 contribution + $6,500 − $5,000) and her RRSP now has an FMV of $148,500 ($150,000 − $6,500 + $5,000). Sarah has shifted $1,500 in value from her RRSP to her TFSA, which she can receive tax-free when she withdraws the funds from her TFSA. Had Sarah withdrawn the same amount directly from her RRSP, she would have been subject to part I income tax.

If such a transfer were repeated over and over again, Sarah could take advantage of the volatility of the stock market to shift value from her RRSP to her TFSA, and withdraw the extra value in her TFSA on a tax-free basis. However, under the advantage tax rules, the increase in the FMV of the TFSA resulting from the swap and the decrease in the value of the RRSP (resulting in an RRSP strip) would both be subject to the 100 percent advantage tax. The double imposition of the tax penalizes Sarah for violating the contribution limit rules in respect of the amount shifted to her TFSA, and for avoiding part I tax on the value shifted out of her RRSP.

As indicated in the example, there is nothing offensive about simply swapping property in a TFSA for cash or other consideration of equal value in the holder’s RRSP. It is the subsequent transaction that makes the first one offensive. Rather than simply

\(^{55}\) See the definition of “excluded property” in proposed subsection 207.01(1).


\(^{57}\) Subsections 146(9) and 146.3(4).
targeting the second abusive transaction, the advantage tax will apply to any transfer of property from a TFSA to an RRSP or RRIF, or from an RRSP or RRIF to a TFSA. There is an expectation by the CRA that many RRSP issuers and RRIF carriers will simply stop processing swap transactions prohibited under the new rules. In this event, individuals wishing to move investments between registered and non-registered accounts to improve the tax efficiency of their investment holdings (such as swapping interest-earning investments outside a registered plan for dividend-yielding investments inside a plan) will be required to liquidate and repurchase, and as a result may incur increased transaction fees or realize accrued losses within the plan.

**In-Kind Contributions and Distributions**

In-kind contributions to registered plans are still permitted, provided that the investment is a qualified investment. A plan issuer that accepts an in-kind contribution of a non-qualified investment could be liable for a penalty. The contribution of a qualified investment is considered to be made at the FMV of the property at the time of the transfer. Any capital gain is included in the individual's income, and any capital loss is denied. Similarly, in-kind distributions may also be made from a TFSA, RRSP, or RRIF. The plan issuer is responsible for determining the FMV of the property. If the value is not properly reported, the individual may obtain an advantage and the plan issuer may be subject to the advantage tax.

**RDSPs—Inadequate Consideration Transactions**

Although the RDSP advantage tax rules do not specifically apply to swap transactions or RDSP strips, the RDSP rules do impose a separate penalty tax on dispositions and acquisitions of RDSP property for inadequate consideration.

Similar to the advantage tax on RRSP strips, if RDSP property is disposed of for consideration that is less than FMV, or RDSP property is acquired for consideration greater than FMV, the holder of the RDSP is liable for a penalty tax equal to the difference between the FMV of the property and the consideration. In certain circumstances, this tax may be waived. (See the discussion below under “Waiver of Tax.”)

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59 Subsections 207.01(5) and 162(7).
61 Subsection 207.05(3).
62 Subsections 206(1) and (2).
IMPACT OF TIGHTER PENALTY RULES ON SPECIFIC INVESTMENTS
Using recent CRA technical interpretations as a guide, the following discussion reviews the impact of the tighter penalty rules on specific types of investments that have commonly been owned in tax-deferred plans.

PRIVATE COMPANY SHARES
Restrictions on private company share investments within registered plans prevent taxpayers from getting around the contribution limit rules and using registered plans to shelter excessive income in non-arm’s-length situations. There are exceptions that allow RRSPs, RRIFs, TFSAs, and RESPs to hold arm’s-length investments in certain private companies. Recently, the exceptions for RRSPs and RRIFs have been tightened to prevent private company share investments that are prohibited investments.

Previously, shares of a private corporation were qualified investments for an RRSP or RRIF if the corporation was either an eligible corporation of which the annuitant was not a designated shareholder63 or a specified small business corporation (“specified SBC”) of which the annuitant was not a connected shareholder.64 The tests are similar except that the eligible corporation test must be met throughout the entire period during which the shares are owned by the registered plan, while the SBC test only needs to be met at the time the shares are acquired by the plan. As a result, most pre-March 23, 2011 private company share investments likely qualified under the specified SBC test.

CURRENT RULES FOR SMALL BUSINESS CORPORATION SHARES
The rules for post-March 22, 2011 RRSP and RRIF investments in specified SBC shares65 mirror the rules for TFSAs that have existed since 2009 and that essentially narrow the eligibility criteria for private company shares acquired after March 22, 2011, by replacing the connected shareholder test with a prohibited investment test.66

For the purposes of the former rules, an individual is a “connected shareholder” if he or she owns (directly or indirectly) 10 percent or more of the issued shares of any class of the corporation or a related corporation.67 For this purpose, the taxpayer is deemed to own shares owned by non-arm’s-length persons. Specifically

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63 Regulation 4900(6).
64 Former regulation 4900(12).
65 Regulation 4900(14).
66 The eligible corporation test in regulation 4900(6) also continues to apply with the added requirement that the shares are not prohibited investments.
67 Regulation 4901(2), the definition of “connected shareholder.” These rules continue to apply for the purposes of the specified SBC test in regulation 4900(12) for RESPs.
excluded from the definition of a connected shareholder is an individual who deals at arm’s length with the corporation and whose investment cost is less than $25,000. The prohibited investment test maintains the 10 percent threshold. However, shares will also be prohibited if the company does not maintain its SBC status at all times.68 The $25,000 low-cost exception has been removed. The following examples illustrate these changes.

Example 2

Facts and assumptions:
- SBCCo is a Canadian corporation operating an active business in Canada.
- Individual A purchased 15 percent of the common shares of SBCCo for $15,000.
- At the time the shares were acquired, SBCCo was a specified SBC.
- Individual A is not related to any of the other shareholders of SBCCo.
- All of the shareholders are Canadian.

Tax consequences:
- **Pre-2011 budget changes:** Individual A has a greater than 10 percent interest but is not a connected shareholder because of the low-cost exemption. Therefore, these shares are a qualified investment and may be transferred to individual A’s RRSP.
- **Post-2011 budget changes:** Individual A has a greater than 10 percent interest in SBCCo, which represents a significant interest. Therefore, the shares are a prohibited investment and a non-qualified investment and cannot be transferred to individual A’s RRSP.

Example 3 illustrates the impact of the 2011 budget amendments in regulation 4900(14) and proposed regulation 4900(15).

Example 3

Facts and assumptions:
- On April 1, 2011, Aco qualified as an SBC.
- On April 1, 2011, individual A purchased 5 percent of the shares of Aco directly and acquired an additional 4 percent of Aco through an RRSP.
- The shares of Aco were not prohibited on April 1, 2011.
- Throughout the remainder of 2011 and in 2012, Aco built up significant earnings.
- In 2012, Aco used those earnings to make a significant investment in a US operating company, such that Aco no longer qualified as an SBC.

Tax consequences:
- The shares were purchased after March 22, 2011 and became prohibited in 2012 when Aco ceased to be an SBC. Accordingly, they are no longer qualified investments.

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68 Proposed regulation 4900(15), replacing existing regulation 5001.
Without the arm’s-length and low-cost exception, it is now more difficult for private company shares to be considered qualified investments. More significantly, they will have to be closely monitored to ensure that they do not become prohibited and subject to the 50 percent tax on their value and the 100 percent advantage tax on income (including capital gains). For a shareholder with significant equity in the business, it may be difficult to swap funds or assets of equivalent value in exchange for the private company shares.

Example 4 illustrates the grandfathering relief available for pre-March 23, 2011 qualified investments. This example is based on a CRA document issued in February 2013.

Example 4

Facts and assumptions:

- Individual B owned 5 percent of the shares of Bco through an RRSP and was not related to any other shareholders.
- Bco was an SBC at the time its shares were acquired by individual B’s RRSP, before March 23, 2011.
- The shares of Bco were a qualified investment at the time they were acquired.
- In 2012, Bco began the process of winding up and selling its business assets, such that it no longer qualified as an SBC.

Tax consequences:

- Since the conditions in regulation 4900(12) only had to be met at the time of acquisition of the shares by the RRSP, the windup and loss of SBC status did not have any impact on the qualified investment status in 2012.
- An investment acquired before March 23, 2011 by an RRSP or RRIF that was a qualified investment because of regulation 4900(12) will continue to retain its qualified investment status under that provision after March 22, 2011, even though that provision has since been restricted to RESPs.

The CRA noted that investments that are qualified because of regulation 4900(14) will no longer qualify if at any time the company ceases to meet the SBC criteria. However, as long as an investment acquired by an RRSP or RRIF before March 23, 2011 qualified under former regulation 4900(12), it will not become prohibited under these new rules. The prohibited investment penalty and advantage tax will, however, apply if shares acquired before March 23, 2011 otherwise become prohibited after October 4, 2011 (for example, where more than 10 percent of the shares are held by the annuitant and non-arm’s-length persons). (For further discussion

69 However, the 50 percent tax will not apply to shares held on March 22, 2011 that first became a prohibited investment before October 4, 2011 under the grandfathering rule in subsection 207.04(1) (coming-into-force provision).

of the relief available in respect of prohibited investments held on March 23, 2011, see below under “Transitional and Other Relieving Measures.”)

**MORTGAGES**

Mortgages in respect of real property situated in Canada are qualified investments for all registered plans as long as the debtor is not a connected person. If the debtor is a connected person, the mortgage may still qualify if it is administered by an approved lender under the National Housing Act, and insured under the National Housing Act or by an approved private insurer of mortgages.

The CRA’s position is that the registration of the plan may be jeopardized and/or certain benefit and penalty provisions may apply where the interest rate and other terms do not reflect normal commercial practice and the mortgage is not administered by the approved lender in the same manner as a mortgage on property owned by a stranger.

The CRA has confirmed that an insured mortgage does not constitute a prohibited investment and therefore continues to qualify for investment in a tax-deferred plan. This position is consistent with the December 2012 draft legislation, which includes an insured mortgage described in regulation 4900(1)(j.1) as “excluded property” in the context of prohibited investments.

**WARRANTS, OPTIONS, AND CONVERTIBLE SECURITIES**

Generally, an option, warrant, or similar security giving the holder the right to acquire property that is a qualified investment (or to receive a cash settlement in lieu of that property) may itself be a qualified investment.

In several recent technical interpretations, the CRA was asked whether the 50 percent tax on prohibited investments would apply if an RRSP or RRIF were to exchange a pre-March 23, 2011 prohibited investment for a new prohibited investment after March 22, 2011.

In one technical interpretation, the CRA stated that where an RRSP or RRIF trust owns shares and related warrants acquired before March 23, 2011 that are a prohibited investment and the exercise of the warrants results in the acquisition of

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71 Regulation 4900(1)(j), and regulation 4901(2), the definition of “connected person.”

72 Regulation 4900(1)(j.1).


75 Paragraph (a) of the definition of “excluded property” in proposed subsection 207.01(1).

76 Regulation 4900(1)(e). Specific guidance on put and call options is provided in IT-320R3, supra note 73, at paragraphs 22 and 23.

shares after March 22, 2011, the 50 percent tax will apply and will be based on the
FMV of the shares at the time of acquisition. The fact that the tax did not apply to
the warrants because they were acquired before March 23, 2011 is not relevant to the
determination. The CRA further stated that the same would be true in the context
of options, convertible securities and other exchanges of securities.

A similar technical interpretation\textsuperscript{78} commented on convertible debt. Essentially,
if a new security is a prohibited investment and it was acquired after March 22,
2011, the 50 percent tax on prohibited investments will apply, regardless of the fact
that the tax would not otherwise apply to the original convertible security because
it was acquired before March 23, 2011.

\textbf{Shares of Cooperative Corporations}

In a recent technical interpretation\textsuperscript{79} the CRA stated that a share of a cooperative
corporation may be a prohibited investment if a plan holder or annuitant has a sig-
nificant interest in the cooperative corporation. The CRA went on to say that a share
of a cooperative corporation that initially qualified may be prohibited where, sub-
sequent to the acquisition, the cooperative ceased to be a “specified cooperative
corporation.”\textsuperscript{80}

\textbf{Escrowed Property}

Property held in escrow is held in trust for someone until certain agreed-upon con-
ditions are met. In general, securities subject to an escrow agreement may not be
transferred or sold, but may entitle the beneficial owner to votes or dividends while
in escrow.

A share of a corporation subject to an escrow agreement may be a qualified in-
vestment if all of the following conditions are met:\textsuperscript{81}

\begin{itemize}
  \item the share has been issued to a plan trust;
  \item the shareholder has all the rights of ownership; and
  \item identical non-escrowed shares are qualified investments.
\end{itemize}

In a recent technical interpretation,\textsuperscript{82} the CRA was asked whether a property
subject to an escrow agreement, being a unit consisting of one common share and
one-half of a warrant, can be held by a TFSA. The CRA confirmed its longstanding

\textsuperscript{78} CRA document no. 2012-0446031E5, September 6, 2012.
\textsuperscript{79} CRA document no. 2012-0441781E5, November 22, 2012.
\textsuperscript{80} Proposed regulation 4900(15), replacing existing regulation 5001, and regulation 4901(2), the
definition of “specified cooperative corporation.”
\textsuperscript{81} IT-320R3, supra note 73, at paragraph 5.
\textsuperscript{82} CRA document no. 2012-0433811M4, May 2, 2012.
position described above, and stated that as long as the escrowed property met the criteria, and the underlying share and warrant were qualified investments, the escrowed property would also be a qualified investment. The CRA also indicated that an appropriate valuation method must be used to determine the value of the warrant.

**Mortgage Investment Corporation**

In general, shares of a mortgage investment corporation (MIC) may be a qualified investment provided that the MIC does not hold any indebtedness of a connected person. Further, as long as the holder of the plan does not have a significant interest in the MIC, the share will not be a prohibited investment. This position is confirmed in two technical interpretations addressing the question of whether a TFSA may hold shares of a MIC.

**Foreign Exchange Trading**

As discussed previously, foreign currency is generally a qualified investment for registered plans. Foreign-currency options that are listed on a designated stock exchange are also qualified.

Foreign exchange contracts that trade over the counter are not qualified because the over-the-counter market is not a designated stock exchange. In addition, where a futures contract is listed on a designated stock exchange but the risk of loss exceeds the cost of the contract, the contract is specifically excluded as a qualified investment. Further, where a plan trust engages in speculative foreign-currency trades, it may be considered to be carrying on a business and therefore be taxable under part 1. Contracts should reflect commercial arm’s-length terms; otherwise, they may be found to artificially shift value into the plan, causing the advantage tax rules to apply.

**Mutual Fund Investments**

Mutual fund investments are generally qualified investments, but may be prohibited if the plan holder has a significant interest and the investment is not excluded property. As described above under “Prohibited Investments,” certain mutual fund investments held during the 24-month startup or windup period of the issuer will be considered to be excluded property and not subject to the prohibited investment rules. Certain arm’s-length, portfolio-type investments will also be excluded property.

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83 Regulation 4900(1)(c).
85 Subparagraph (b)(i) of the definition of “advantage” in proposed subsection 207.01(1), and CRA document no. 2010-0356811E5, January 5, 2011.
TRANSITIONAL AND OTHER RELIEVING MEASURES

A number of specific measures provide relief from the penalty rules.

TRANSITIONAL RULES APPLICABLE TO RRSPs AND RRIFs

Transitional Prohibited Investment Benefit Election

Recall that the 100 percent advantage tax applies to income earned from prohibited investments held after March 22, 2011, and to capital gains accruing after that time and attributed to such investments. However, an election is available not to have the 100 percent advantage tax apply provided that the qualifying income or gains are withdrawn (annually) from the RRSP or RRIF.87 The qualifying income and gains for a taxation year are reduced by any capital losses realized in the year that are attributable to an investment that was a prohibited investment on March 23, 2011, and that accrued after March 22, 2011.88 The net amount is referred to as a “transitional prohibited investment benefit.”89

This relief was originally available only for income earned and capital gains realized before 2022, but the termination date has since been removed. This change is welcome news for individuals who hold illiquid private company investments that became prohibited investments on March 23, 2011, and who do not have the necessary funds available to swap the investment out of the RRSP or RRIF.

To take advantage of the transitional relief, the annuitant was required to file an election before March 2, 2013.90 In addition, the transitional prohibited investment benefit for a calendar year must be withdrawn within 90 days after the end of the year, and the withdrawal cannot be paid by way of a transfer to another registered plan of the annuitant.

The withdrawn amount is included in income for the year and is subject to the annuitant’s marginal tax rate (just like any regular RRSP or RRIF withdrawal).

Swapping Out Non-Qualified and Prohibited Investments

A transitional rule permits a swap transaction to be undertaken before 2022 to remove any property from an RRSP or RRIF that would, if retained in the plan, result in the 50 percent penalty tax. Individuals should identify any investments that could potentially become prohibited or non-qualified investments and should plan to remove such investments before 2022 or restructure their holdings so that they do not fall offside.

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87 Proposed subsection 207.05(4).
88 See supra note 27.
89 Defined in proposed subsection 207.01(1).
90 CRA form RC341, “Election on Transitional Prohibited Investment Benefit for RRSPs or RRIFs.” The election was originally required to be filed before July 2012; however, the deadline was extended to allow more time for individuals to determine whether they needed to apply for transitional relief.
When swapping out a non-qualified or prohibited investment, it is important to ensure that the RRSP or RRIF receives FMV consideration for the property; otherwise, the swap may be considered to be an RRSP strip. In this respect, caution should be exercised where the value of the investment is not easily determined (as in the case of private company shares).91

Refund of Penalty Tax

In the case of TFSA, RRSPs, and RRIFs, the 50 percent penalty tax may be refunded if the investment is disposed of by the end of the calendar year following the year in which the tax applied (or such later time as the CRA considers reasonable). No refund will be allowed if the holder or annuitant knew (or should have known) at the time the investment was acquired that it was, or would become, a non-qualified or prohibited investment.92

Further, if a part XI.01 return is not filed within three years after the end of the relevant year, the individual may be precluded from receiving the allowable refund (subject to the taxpayer relief provisions).93

Similar refund provisions (with similar conditions) apply for the RDSP penalty tax on non-qualified investments.94

There is no refund provision for the 1 percent monthly tax on RESPs holding non-qualified investments.

Double Taxation Relief

If at any time an investment is both a prohibited and a non-qualified investment, the investment is deemed not to be a non-qualified investment for the purposes of the 50 percent penalty tax and the part I tax applicable to income earned by the trust on the investment.95 This relieving rule ensures that the holder or annuitant is subject to only one penalty tax regime in respect of the investment and any income earned on the investment.

For RRSPs and RRIFs, this relieving rule applies to prohibited investments that were acquired after March 22, 2011, or that were acquired before March 23, 2011 and first became prohibited after October 4, 2011. It also applies to non-qualified investments that were acquired, or that first became non-qualified, after March 22, 2011.

It is the CRA’s view that this relieving rule does not apply in circumstances where non-qualified private company shares acquired before March 23, 2011 continue to be held after March 22, 2011 and are considered to be a prohibited investment on

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92 Subsection 207.04(4).
93 Section 207.07 and subsection 164(1.5).
94 Subsections 206.1(4) and 207(2) and (4).
95 Subsection 207.04(3).
March 23, 2011 (for example, where a person related to the annuitant owns more than 10 percent of the shares of the company). In this situation, the investment will continue to be considered both a prohibited and a non-qualified investment, and income earned, and capital gains accruing, on the investment (after March 22, 2011) may be subject to both the advantage tax imposed on the annuitant and regular part I tax imposed on the trust. The transitional prohibited investment benefit election would provide relief from the advantage tax in such a situation; however, if the election was not filed by the due date, the annuitant should apply to the CRA for a waiver of the part XI.01 tax.96

**Deemed Disposition and Reacquisition**

When a property held within a TFSA, RRSP, RRIF, or RDSP ceases to be a non-qualified or a prohibited investment, the plan trust is deemed to have disposed of the investment at that time for proceeds equal to its FMV at that time and to have reacquired it at a cost equal to that FMV.97 This ensures that regular part I tax applicable to the trust or the advantage tax applicable to the annuitant or holder ceases to apply to any income earned, and gains accrued, on the investment after that time.98

This rule may accommodate circumstances where an individual does not wish to dispose of a particular investment within a registered plan that is a non-qualified or a prohibited investment. This may be the case where securities are a prohibited investment because the individual’s holdings inside and outside a registered plan represent a significant interest, and it would be more desirable to dispose of the same securities held outside a registered plan to reduce the individual’s interest in the entity (for example, to trigger capital losses that can be used to offset taxable capital gains, or to continue to shelter dividend income on the securities held within the registered plan).

The deemed disposition of a non-qualified or prohibited investment is considered to be a disposition for the purposes of the refund rules. Therefore, it is not necessary for the plan to actually dispose of the investment for the holder or annuitant to qualify for a refund of the penalty tax.

A similar deemed disposition and reacquisition rule applies when property held by a TFSA, RRSP, or RRIF becomes a non-qualified or prohibited investment. This rule ensures that any gains that accrued prior to the time when the investment became non-qualified or prohibited are not subject to the advantage tax.

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97 Subsection 206.1(6), and existing subsection 207.04(5), which is to be replaced by proposed subsection 207.01(6).
98 Under subsections 146(10.1), 146.2(6), 146.3(9), 146.4(5), and 207.05(1).
Waiver of Tax

The CRA has the authority to waive certain penalty taxes.

RRSPs, RRIFs, and TFSA

The CRA may, at its discretion, waive all or a portion of the 50 percent penalty tax or the 100 percent advantage tax if it considers it just and equitable to do so, taking into account the particular circumstances, including specifically the following:\n99

- whether the tax arose as a consequence of a reasonable error;
- the extent to which the transaction or series of transactions that gave rise to the tax also gave rise to another tax under the Act; and
- the extent to which payments have been made from the person’s registered plan.

The additional requirement that amounts giving rise to the advantage must be withdrawn without delay is repealed in the December 2012 draft legislation. The CRA has published guidance and examples of circumstances in which a waiver may be granted.\n100 The CRA has stated that it will administer the waiver provisions in a fair and flexible manner in order to promote voluntary compliance with these new rules and to encourage taxpayers to come forward and correct situations that are offside of the new rules, particularly those that involve pre-March 23, 2011 investments.\n101

RDSPs

The CRA also has the discretion to waive all or a portion of the tax payable in respect of the various penalty provisions for RDSPs (including tax payable for inadequate consideration, tax payable on non-qualified investments, and advantage tax).\n102 A waiver will be granted in circumstances similar to those described above. The CRA has not issued specific guidance on waiver requests for RDSPs, but given the similarity in the wording of the provision, it is likely that the form of the request and the conditions for favourable consideration would be similar to those discussed above.

RESPs

There is no waiver provision in the context of the 1 percent per month tax on RESP holding non-qualified property.

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99 Proposed subsection 207.06(2).
101 Ibid.
102 Section 206.4.
Withdrawals from Locked-In Retirement Accounts and Retirement Income Funds

Because of restrictions on withdrawals from locked-in retirement accounts and locked-in retirement income funds, it may not be possible for the annuitant to withdraw amounts giving rise to the penalty taxes. However, the CRA has recommended the following to mitigate any adverse tax consequences under the penalty rules:103

- The amount may be withdrawn from the annuitant’s unlocked RRSP or RRIF instead of the locked-in plan. (There is no requirement for the withdrawal to be made from the particular plan.)
- A prohibited investment could be swapped out of the locked-in plan for FMV consideration to stop the advantage tax from applying to future investment earnings.
- The applicable provincial pension laws should be reviewed to determine whether there are any other options, such as transfers between plans or the capability for some unlocking.

The CRA has also indicated that the withdrawal of a transitional prohibited investment benefit from a RRIF may be taken into consideration in satisfying the RRIF carrier’s obligation to pay the minimum amount from the RRIF.104

CONCLUSION

With registered savings plans being an important component of Canadian investment portfolios and financial plans, it is important for tax advisers and their clients to understand the types of investments that can be held within the various plans. The tighter anti-avoidance rules for RRSPs, RRIFs, and TFSSAs have added new complexities that require closer monitoring of investments held within, and transactions undertaken in connection with, registered savings plans. The new penalty rules may also create an increased compliance burden.

The penalty taxes must be remitted and reported annually, and failure to remit and file on time may result in additional penalties. It will therefore be important to review changes in the FMV of registered plans annually in order to determine the amount of any advantage, and to review investment holdings on a more frequent basis in order to determine whether any investments have become non-qualified or prohibited. It may also be difficult to determine whether an investment is offside without understanding what investments are held by family members and other non-arm’s-length persons. In many cases, it will be important to remove offside investments as soon as possible. In the case of private company investments, this may require a proper valuation of the shares.