The Joint Committee on Taxation of The Canadian Bar Association and The Canadian Institute of Chartered Accountants

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October 28, 2011

Mr. Brian Ernewein
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Tax Policy Branch
Department of Finance
L'Esplanade, East Tower
140 O'Connor Street, 17th Floor
Ottawa, ON K1A 0G5

Re: Bill C-13 – Proposed Changes relating to RRSPs and RRIFs

Mr. Ernewein,

Enclosed is our submission on the legislative proposals contained in Bill C-13 that propose to extend the anti-avoidance provisions in the context of tax-free saving accounts to registered retirement savings plans ("**RRSPs**") and registered retirement income funds ("**RRIFs**") (the "**Legislative Proposals**"). We greatly appreciate the opportunity to comment on the Legislative Proposals.

We recognize that the aim of the Legislative Proposals is to stop what might be perceived as certain abusive transactions, but we have serious concerns that the scope of the proposed changes go far beyond what is needed to prevent the abuses and will have adverse implications on what have until now been long-standing acceptable investments for RRSPs and RRIFs. We also seriously question the impact that the proposed rules will have on the ability of taxpayers to rearrange their existing business arrangements and investments (acquired under clear and unambiguous rules) on a timely basis to satisfy the grandfathering provisions. Moreover, we are quite concerned about the future impact that the proposed changes will have on the ability to promote private investments with funds in RRSPs and RRIFs, and that this may curtail what has been a significant source of capital for growth in the Canadian economy.

We have received numerous comments from concerned members of the tax community that bring into question the need for the proposed changes on a broad base, and that in any event, strongly support a complete or more favourable grandfathering for existing qualified investments. We believe that our enclosed submission, which addresses certain overall policy matters and technical issues that will arise in applying the Legislative Proposals, will help highlight our concerns. We would be pleased to discuss the issues raised with you and members of your Department at your convenience.

Several members of the Joint Committee participated in discussions concerning our submission and contributed to its preparation, in particular:

D. Bruce Ball (BDO Canada LLP)
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We trust that you will find our comments helpful.

Yours very truly,

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Submission of the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants regarding the Proposed Changes in Bill C-13 relating to RRSPs and RRIFs

The Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants is pleased to provide you with this written submission on the draft legislative proposals contained in Bill C-13 that extend certain anti-avoidance provisions in the context of tax-free saving accounts ("**TFSAs**") to registered retirement savings plans ("**RRSPs**") and registered retirement income funds ("**RRIFs**") (the "**Legislative Proposals**").

Unless otherwise indicated, references to subsections, paragraphs, etc., are to provisions of the *Income Tax Act* (Canada) (the "**Act**") as proposed to be amended under the Legislative Proposals. Also, in many instances in this submission we refer only to RRSPs although our comments are generally equally applicable to RRIFs.

1. Overall Policy Objection

As an introductory comment, we accept the stated objective of the Legislative Proposals of stopping abusive tax schemes such as RRSP strips, but we are concerned that a blanket extension of the TFSA anti-avoidance rules to RRSPs has far-reaching effect beyond what is necessary to stop any abuse. As well, as drafted we believe the proposals apply to a broad range of investments that have historically been acceptable and, in fact, encouraged as a means of promoting investment in the Canadian economy and saving for retirement.

We therefore question the broad scope of the proposed changes and the fundamental change in tax policy underlying qualified investments for RRSP purposes. We wonder whether certain long-standing qualified investments for RRSP purposes should specifically be carved out, or whether the proposed rules should be tailored to prevent or address specific abuse or policy concerns.

Given that the Committee is providing a detailed submission on a set of rules that previously existed for TFSAs, a logical question is why were these issues not raised previously in the context of TFSAs? There is a clear answer to this question. We see a fundamental difference behind policy concerns and restrictions applying to TFSAs where withdrawals come out tax free (and moreover create room for future reinvestment) in comparison to RRSPs where withdrawals are fully taxed (and moreover, taxed at higher rates in comparison to what may have been earned inside the RRSP as in the case of capital gains and dividends). In particular, many have interpreted the government's response to TFSA investments as making it clear that only widely-held and publicly traded investments will be allowed in TFSAs. Given the beneficial nature of a TFSA and its stated purpose, this seems reasonable in the context of TFSAs. However, the same is not true for RRSPs as a long-term vehicle for retirement. In other words, we suggest that prudent rules set for TFSAs may be unfair if extended broadly to investments that are otherwise qualified for RRSPs.

We note that an RRSP is more complicated than a TFSA since a deduction is allowed for contributions, and the appreciation will be taxed later after a period in which tax on appreciation and income is deferred. Many investors will contribute funds and immediately buy an investment as part of a predetermined transaction, and will generally take the tax saving from the RRSP contribution into account when determining the contribution amount (if not contributing the maximum amount). This will be especially true where there is a need to buy an investment (for example, a private company investment) and the individual has significant RRSP room. Also, for pre-existing RRSP funds, many use an RRSP to make a specific investment because that is where their capital is, and not necessarily because they specifically want that investment to be in an RRSP. Again, where there is a particular need to make the investment, using an RRSP means that borrowing funds to complete the investment may not be required.

The proposed blanket extension of the anti-avoidance provisions for TFSAs to RRSPs and RRIFs appears to be the harshest on private company investments. At one time, these investments were actually encouraged, as they created a greater limit for foreign investments when foreign property limits applied. In this regard, at least historically, the government established specific lists of qualified investments for RRSPs. We assume that a number of other items that are not on the current lists were historically reviewed but ultimately not approved. We further assume that this process recognized that there are private investments that are acceptable, but at the same time, not widely traded. Extending the TFSA restrictions to many such private investments brings into question the policy behind the current lists of qualified investments for RRSPs and RRIFs.

We seriously question the impact of the proposed restrictions in a number of particular areas, mostly, but certainly not exclusively, involving private company investments. The following are some examples where we see concerns arising:

- *Private company shares where the annuitant owns less than 10% at outset but the ownership increases beyond 10% thereafter*: Private company shares are currently qualified investments for RRSPs under Regulation 4900(12) if, at the time the shares are acquired, the annuitant (either alone or together with any non-arm's length persons) holds less than 10% of the shares of the private company. If a subsequent acquisition or disposition of shares occurs (which the annuitant may not be involved in or know about) that results in the ownership of 10% or more, the investment will become a prohibited investment under the Legislative Proposals and subject to the 50% of fair market value tax while income and gains will be subject to the 100% advantage tax. The ownership of shares could extend beyond the annuitant and his or her immediate family, and can thereby apply to ownership of shares by siblings, nieces and nephews, as an example, due to the use of a non-arm's length test. In many cases, the annuitant may have no means of knowing whether such ownership of shares even arises, and privacy laws simply may not allow for a means of obtaining such information or monitoring share ownership thresholds.

- *Private company shares where the company is a specified small business corporation at outset but ceases to be thereafter*: Private company shares are currently qualified investments for RRSPs under Regulation 4900(12) if, at the time the shares are acquired, the shares are capital stock of a specified small business corporation. As a result of proposed Regulation 4900(14) and Regulation 5001, if a subsequent event occurs within the private company that has the effect of having the company cease to be a specified small business corporation (such as, for example, where all or substantially all of the fair market value of the assets of the company are no longer attributable to assets used in an active business carried on primarily in Canada by the company or by a corporation related to it, or where the company becomes controlled, directly or indirectly in any manner whatever, by one or more non-resident persons), the investment will become a prohibited investment under the Legislative Proposals and subject to the 50% of fair market value tax while income and gains will be subject to the 100% advantage tax. In most cases, the annuitant will have limited means of knowing whether the asset test and non-resident ownership restrictions for being a specified small business corporation are met and, moreover, will have no real means of controlling or influencing such an event. As a result, many private company investments may effectively become disqualified, from a practical perspective, because the company will almost certainly be unable (or unwilling) to warrant that the asset and ownership restrictions will continue to be met at all times and without such a warranty or certainty, the annuitant (and the issuer of a RRSP or the carrier of a RRIF) will not be prepared to accept the risk that the investment could become prohibited.

- *Private company shares where the annuitant owns more than 10% at outset*: By virtue of the definition of a "connected shareholder" in Regulation 4901(2), private company shares were, prior to the proposed amendments to Regulation 4900(12), qualified investments for RRSPs where an arm's length annuitant held more than 10% of the shares of certain qualifying private corporations provided the cost amount of the shares was less than $25,000. Such an investment that was specifically qualified as an investment for RRSPs will now be a prohibited investment under proposed Regulation 4900(14).

- *Public company shares and other investments where the annuitant owns or acquires more than 10%*: Public company shares will now be prohibited investments for an RRSP if the annuitant of the RRSP, together with non-arm's length persons, owns 10% or more of the shares of any class or series of the public company. Even if the annuitant, together with non-arm's length persons, tries to limit ownership to less than 10% of a class or series, subsequent redemptions of shares held by arm's length persons, which are entirely outside the control of the annuitant, could cause the penalty taxes to apply. Moreover, ownership of shares extends beyond the annuitant and his or her immediate family, and can thereby apply to ownership of shares by siblings, nieces and nephews, as an example. Again, the annuitant may have no means of knowing whether the 10% ownership threshold is exceeded, and privacy laws may not allow for a means of obtaining such information or monitoring share ownership thresholds. In addition to investments that had no ownership limit, there are other investments that had a specific ownership level that is based on a specific rule. For example, to meet the conditions for mortgage investment corporations, a 25% ownership test must be met and we understand that the test was formulated knowing that RRSPs would hold these investments.

- *Investments in other entities where the annuitant owns more than 10%*: An investment in a corporation, partnership or trust that otherwise would be a qualified investment and in which the annuitant does not have a significant interest, will be a prohibited investment under subparagraph (b)(ii) of that definition in the proposed rules if the annuitant owns 10% or more of any class of shares of the capital stock of a corporation or 10% or more of the interests of a partnership or trust with which the qualified investment entity does not deal with at arm’s length. For example, assume that a RRSP of a particular annuitant does not have a significant interest in a mutual fund trust or a public corporation but the annuitant owns, outside his RRSP, 10% or more of a class of shares of the capital stock of a corporation with which the mutual fund trust or public corporation does not deal at arm’s length (which may arise for bona fide commercial reasons), which shares are not themselves qualified investments. The ownership of the shares, which themselves cannot be held in the annuitant’s RRSP, would cause the interests in the mutual fund trust or public corporation to be prohibited investments that are subject to the 50% of fair market value tax and 100% advantage tax even though the annuitant does not have a significant interest in that mutual fund trust. The same result may arise if an annuitant owns 10 percent or more of the interests of a limited partnership in which a wholly-owned corporate subsidiary of the mutual fund trust is the general partner regardless of the percentage ownership of the mutual fund trust interests. There are numerous possible combinations where investments held outside a RRSP may cause an otherwise qualified investment to be a prohibited investment and thereby subject to the penalty taxes, in many cases, in circumstances of which the annuitant is not even aware.

- *Significant Interest in the Context of Mutual Fund Corporations does not reflect commercial reality*: Many mutual fund corporations issue multiple classes of shares each of which represents a separate "fund" in the sense that the return on, and redemption value of, the shares of a particular class are tied to a particular portfolio of assets owned by the mutual fund corporation. Typically, each class of shares also has multiple series of shares, to permit holders to purchase the shares of the class on the basis of different sales charge arrangements (for example, upfront sales charge, charges when shares are redeemed, or for fee based accounts). Because of the multiple series available in each class, it would not be unusual for a particular series to have a single holder of more than 10% of the shares although that would represent a smaller percentage of the class as a whole and an even smaller percentage of the mutual fund corporation itself. Moreover, because mutual fund corporation shares are redeemable on demand and often convertible into shares of another class, the percentage interest of a particular holder in a particular series may vary from day to day. There is simply no means by which the holder of shares of a particular series will know whether the 10% threshold has been exceeded. We understand that the Investment Funds Institute of Canada has made a submission to the Department of Finance recommending, among other things, that mutual funds that are subject to National Instrument 81-102 be exempt from these rules. We endorse that recommendation.

Recommendation

We recommend that the Department of Finance reconsider the scope of the proposals and fine tune them so that they only prevent abuses that the rules are intended to stop. We further recommend that the Department of Finance reconsider the need for policy changes regarding the 10% ownership limitations and the requirement for a constant need for private investments to be qualified rather than simply being a qualified investment at the outset (particularly in situations where an annuitant may have no means of monitoring or controlling the conditions for qualification). We recommend that the Department of Finance consider a more focused set of rules in the context of RRSPs and RRIFs rather than applying the broader set of rules that were developed in the context of TFSAs, particularly as the tax consequences of investing through an RRSP or RRIF merely leads to a deferral of tax and also has the effect of raising the tax rate on certain income such as capital gains and dividends. In considering this recommendation, we encourage the Department of Finance to consider the overall policy behind the proposed blanket extension of the TFSA anti-avoidance provisions to RRSPs and RRIFs to determine the future impact that such extension will have on many private and public investments that have long been acceptable and a very important source of capital for growth in the Canadian economy while building up savings for retirement. Without such review and consideration, we are concerned that the ability to make any private investment in an RRSP or RRIF will effectively be eliminated, and that certain public investments will be a problem when there seems to be no policy reason to restrict such investments.

2. Grandfathering Provisions

As a general comment, strict rules could be introduced for TFSAs without significant transitional issues, as TFSAs were new and the amount invested in TFSAs was insignificant compared with RRSPs. As mentioned previously, we generally are in agreement with the concept of setting strict TFSA rules given the tax-free nature of these plans and that the strict rules were established when the TFSA concept was in its infancy. In contrast, we believe that significant transitional issues will arise if the TFSA anti-avoidance rules are imposed with respect to existing investments in RRSPs.

We recognize the introduction of a partial grandfathering for prohibited investments held in RRSPs on March 22, 2011, with the income that is earned after March 22, 2011 and before 2022 and the gains accruing after March 22, 2011 and realized before 2022 not being subject to the 100% advantage tax and instead being subject to tax as effectively a mandated RRSP withdrawal provided such income or gain is paid to the annuitant of the RRSP within 90 days after the end of the relevant taxation year and the annuitant makes an election in respect of the benefit and investment before July 2012. However, income or gains in respect of a grandfathered investment that are earned or realized after 2021 will become subject to the 100% advantage tax, effectively requiring the grandfathered investment to be disposed of or withdrawn from an RRSP or RRIF before 2022.

In many cases, the funding required to accomplish such a withdrawal simply may not be available. It may not be possible to come up with other non-registered qualified investments to swap out the prohibited investment, and it may not be possible to borrow sufficient funds to purchase the grandfathered investment from the RRSP. This may be particularly true when one considers the potential gains and value that have accrued in respect of private investment made in an RRSP. As indicated above, the clear and detailed rules in the Act and historic policy behind the RRSP rules encouraged private company investments without restraint on whether the investment was made in the context of an advantage transaction or a future 10% ownership limitation that the proposed prohibited investment rules will now introduce. Abiding by the clear and detailed rules and public policy has led to significant investment and growth in the Canadian economy in a wide range of sectors including the oil and gas and technology industries. Private company investments are, by their nature, illiquid. It simply may not be possible to sell the investments or borrow sufficient funds against them as security to take the investments out of an RRSP in the next ten years. Requiring such investments to be sold from an RRSP ahead of a normal commercial sale or liquidation date or to attempt to borrow against their illiquid value will lead to harsh and non-economic results for taxpayers who followed the clear and unambiguous rules for acquiring such investments in the first instance. It would be far more equitable, if still considered necessary from a policy perspective, to impose the new prohibited investment limitations in the context of RRSPs to new investments only.

Recommendation

We have the following recommendations concerning the grandfathering provisions:

1. To the extent that the Legislative Proposals are not more focused to target specific abusive investments, we recommend a complete grandfathering and exemption from the 100% advantage tax for all investments held in an RRSP or RRIF on March 22, 2011, or at least a complete exemption for investments where the arbitrary 10% threshold has been exceeded or

where there is some uncertainty as to whether the investment may have been acquired in an advantage scenario. Simply put, investments that are prohibited solely because the 10% threshold has been exceeded or solely because there is some uncertainty on the application of the advantage rules on March 22, 2011 due to the open market test should be grandfathered indefinitely. The broad introduction of these new rules in the context of RRSPs and RRIFs is not merely closing a loophole. It is a brand new tax policy that should apply only on a going forward basis (if at all).

2. If a complete grandfathering is not introduced, we recommend at a minimum that the proposed grandfathering for prohibited investments under the "transitional prohibited investment benefit" rule be applied on a permanent basis until the investment is otherwise sold or disposed of. Such a change to the grandfathering provisions would prevent the unfairness associated with having to sell or borrow against illiquid private investments, as an example. A further consideration to permanent grandfathering for a March 22nd prohibited investment would be to allow for a transition period (say two to three years at the least) to allow an RRSP/RRIF to dispose of a March 22nd prohibited investment, with income and gains earned/realized on the investment during that period being excluded from the advantage tax (i.e., so that the related income/gains would not need to be immediately distributed and taxed at full rates).

3. We also recommend that if a complete grandfathering is not introduced, a more logical deadline to distribute the income or realized gains from the RRSP or RRIF would be April 30th, to coincide with tax filing deadlines, as opposed to 90 days.

4. Lastly, we recommend that rules be introduced to contemplate that a grandfathered investment will continue to be a grandfathered investment following a corporate reorganization (such as a reorganization of capital under section 86 or an amalgamation under section 87) or a permitted share exchange (such as a share exchange under section 51, 85 or 85.1). The rules should permit various reorganizations and share exchanges without jeopardizing grandfathered status.

3. 100% Advantage Tax is Excessive and Confiscatory

The Legislative Proposals introduce a 100% advantage tax for all income or gains to the extent that a prohibited investment is made in an RRSP or RRIF, as well as in various other circumstances. We strongly feel that the imposition of a 100% penalty tax is confiscatory and should apply only where there is some intentional misconduct, or at the very least should provide for a due diligence defence rather than waiver at the discretion of the Minister in certain narrow circumstances. There are also many instances where it may be unclear whether an advantage transaction exists that would cause the investment to be offside, such as in the case of whether the transaction is an "open market" one. The Act does not penalize reprehensible conduct and even deliberate fraud as harshly as the Legislative Proposals propose to penalize what in many cases may be an innocent mistake or a question of interpretation, or the result of transactions that were undertaken before the Legislative Proposals were publicly announced based upon the law that existed at the time. The 100% advantage tax was designed for TFSAs, which are tax-free and were brand new. That framework is not appropriate for RRSPs and RRIFs, and in particular, in a manner that is retroactive for investments that cannot easily be transferred out of an RRSP or RRIF.

__Recommendation__

We recommend that the advantage tax be set at ordinary rates for the taxation of income provided that the advantage is withdrawn from the RRSP within a reasonable period of time (which period should be significantly extended if the annuitant is not aware that he or she is subject to the 100% tax). This period of time should be tied to the assessment of the penalty as there will be situations where the existence of an advantage will not be clear. If a penalty is to be imposed, we recommend that the penalty be imposed in the same way that other penalties are imposed under the Act, with a due diligence defence, rights of review and appeal as to the appropriateness of the penalty.

4. The 10% Significant Interest Test is Not Appropriate and is too Broad

We believe that the 10% non-arm’s length "significant interest" test used in the context of the "prohibited investment" rules is inherently vague and inappropriate where the penalty for being wrong is a 100% tax. The rules should be capable of very clear application given the penalties imposed. The test should only include persons who are "related" to the controlling person and the definition of related should be modified for these purposes to only include spouses and minor children and corporations controlled by such persons. Also there should be no reference in the specified shareholder definition to corporations related to the particular corporation. The point is that whether persons may or may not deal with each other at arm's length is often vague, uncertain and open to debate. Moreover, relatives such as siblings, aunts, uncles, nieces and nephews will frequently not know what investments, if any, each other are holding, and privacy laws may prevent obtaining the information necessary to determine share ownership thresholds. Any legitimate taxing provision in a voluntary reporting system such as Canada’s must be based on the premise that the information needed to determine the tax liability is reasonably available to the taxpayer.

__Recommendation__

We recommend that the 10% ownership threshold be increased to a higher percentage, such as 25%, and that the test be based on a clearly defined category of related persons rather than the broad non-arm's length tests used in the context of the "specified shareholder" rules. Rules similar to the 25% ownership limitations that were created in the context of “mortgage investment corporations” and “investment corporations” would be a more appropriate standard. Those rules were the subject of a consultation process in the late 90s, which culminated in a 25% modified related person ownership test that would appear to be sufficient to achieve an implicit objective of ensuring that no individual controls an entity invested in by his or her deferred plan, but without the inherent uncertainty and excessiveness that the proposed 10% non-arm’s length test imposes. Alternatively, if less immediate relatives or a non-arm's length standard is used on an inclusive basis, the ownership combination should, at a minimum, require a combined participation and actual knowledge concerning the acquisition and ownership of shares (in other words, a due diligence test). In this way, taxpayers will not be held liable for something beyond their control and knowledge.

5. Uncertainty of "Open Market" Requirement

We have interpretation concerns with the scope of the definition of an "advantage" in subsection 207.01(1), and in particular with whether a transaction or event or a series of transactions or events would not have occurred "in an open market in which parties deal with each other at arm's length and act prudently, knowledgeably and willingly". Specifically:

- The CRA has confirmed that these rules apply to freeze transactions with respect to private company shares for TFSA purposes. While this provides some guideline on the scope of the open market limitations, due to the broad wording, it may be difficult to have other private company investments made inside an RRSP. This result appears to frustrate any policy objective of encouraging growth and investment in the private sector. Due to the significant savings that many Canadians have built up in their RRSPs (which we understand was precisely the objective of those rules), RRSP accounts may be the only real source of capital for many to invest from.

- We are concerned that the broad wording of the advantage rules and trustee risk management decisions may practically mean that any investment that is not publicly traded may be non-eligible in practice. Plan trustees can decide not to allow certain investments or impose conditions or costs that make the investment difficult or cost prohibitive to hold in an RRSP. This is particularly true given the potential exposure of an issuer of an RRSP and the carrier of a RRIF under proposed subsection 207.01(5).

- The ability to hold many private investments in an RRSP is dependent on obtaining a clean tax opinion as to the qualified nature of the investment for RRSP purposes. Most RRSP administrators require an opinion for private investments. We believe the current proposals will make it extremely difficult for a clean tax opinion to be issued. Tax advisors may not be comfortable or perhaps even qualified to provide an opinion as to whether an investment could be available "in an open market in which parties deal with each other at arm's length and act prudently, knowledgeably and willingly".

- Opinions on the prohibited investment rules will also be difficult when it becomes necessary to conclude whether parties are dealing with each other at arm's length, particularly in a situation where there may be a common bond among the investors or where there is a mutual financial motive or investment decision being made. It may be that clean opinions cannot be rendered on this point in any closed market transaction where the parties are otherwise arm’s length and hold interests of less than 10%.

Recommendation

We recommend that the open market requirement be more clearly defined. A more objective test must be created. Without more objectivity, it is possible that most private company investments held in an RRSP or RRIF will give rise to the 100% advantage tax, and that from a practical perspective, it will no longer be possible to have private company investments made through an RRSP or RRIF in the future, particularly when one takes into account the potential exposure for the annuitant and the issuer of the plan.

Since we assume the main concern is an unreasonable return on an investment, we would suggest a more specific test. As an example, we would draw your attention to the definition of a benefit for Registered Disability Savings Plans (RDSP) under subsection 205(1):

“’benefit’ , in relation to a registered disability savings plan, includes any payment or allocation of an amount to the plan that is represented to be a return on investment in respect of property held by the plan trust, but which cannot reasonably be considered, having regard to all the circumstances, to be on terms and conditions that would apply to a similar transaction in an open market between parties dealing with each other at arm's length and acting prudently, knowledgeably and willingly.”

We believe that a similar rule could be adopted for the purposes of RRSP and RRIF advantages as these plans have much more in common with a RDSP than a TFSA in terms of how plan income is taxed. If an investment return met these conditions, then the investment return itself should specifically not be an advantage. We also believe this rule will be easier to apply in practice.

If there are other possible investment attributes that cause your Department concern, we would encourage you to deal with these specific concerns directly to ensure that fewer non-controversial arrangements are negatively impacted.

6. Timing Considerations

The proposals apply to transactions occurring, income earned, capital gains accruing and investments acquired after March 22, 2011. With respect to certain investments such as an interest in a trust or a partnership, the taxpayer may not technically earn the income until the end of the year of the trust or partnership. This could result in amounts that have been paid or accrued to an RRSP before March 23, 2011 effectively being an advantage because the income technically may have been earned by the RRSP after March 22, 2011 even though the income was actually received or earned by the trust or partnership before the announcement date. This treatment is inconsistent with the treatment of capital gains as only the portion of the capital gains accruing after announcement date is included as an advantage.

We also note that the definition of transitional prohibited investment benefit does not apply properly where an RRSP realizes a gain that accrued in part before March 23rd. The definition “means” a “capital gain realized....if...in the case of a gain, it accrues after March 22, 2011.....”. A gain realized prior to 2022 that partially accrued prior to March 23rd would not seem to fall within this definition (i.e., since the entire gain did not accrue after March 22nd). The coming-into-force rule in the application of the advantage definition for gains refers to “gains accruing after March 22nd”. It’s not clear whether this is intended to mean “an increase in value that occurs after March 22nd”, or whether it is intended to mean “where a gain is realized, the portion of the gain accruing after March 22nd”. In other words, can the RRSP/RRIF recover, after March 22nd, some or all of its original cost without incurring tax. For example, if an RRSP can demonstrate that its cost of an investment exceeded the value of the investment on March 22, 2011 and it disposes of the investment for proceeds less than the original cost but greater than the March 22, 2011 value, there should be no overall gain to the RRSP and therefore no gain accruing after March 22nd.

Recommendation

We recommend that the rules be clarified to allow for adjustments for stub period income in the context of trusts, partnerships and other similar investments. We also recommend that the coming-into-force provisions and the definition of “transitional prohibited investment benefit” be modified to clarify how a gain is to be calculated for the purpose of the advantage rules and to ensure that the portion of any such gain included in the advantage definition in respect of an investment held at March 22, 2011 is also included in the definition of transitional prohibited investment benefit.

7. Uncertainty for Historical Transactions

Pursuant to clause 64(6) of the Legislative Proposals, the extension of subparagraph (b)(i) of the definition of “advantage” in subsection 207.01, as well as various other amendments, applies "to transactions occurring, income earned, capital gains accruing and investments acquired, after March 22, 2011..."

In circumstances where a transaction occurred before March 23, 2011 but an increase in fair market value which might be said to be attributable to that transaction arises after March 22, 2011 as a result of income earned or gains accruing after that date, it appears to be possible to interpret the legislation as meaning that such income or gain results in an "advantage" for a RRSP or RRIF if the transaction did not satisfy the tests in clauses (A) and (B) of subparagraph (b)(i), above.

Such an interpretation of the coming into force provision could result in historical pre-budget transactions that might have failed the open market tests in clauses (A) and (B) above being far more onerously treated than prohibited investments acquired before that date or historical swap transactions.

Recommendation

We recommend that the coming into force provisions be clarified to ensure that transactions that occurred before March 23, 2011, or which are part of a series of transactions beginning before that date, do not result in an advantage for an RRSP or RRIF solely because the transaction or series may have failed the open market tests in subparagraph (b)(i) of the definition of advantage.

Alternatively, and while we believe it would be inappropriate to apply the new rules to historical transactions, if the new rules are intended to apply as a result of historical transactions, then a transitional mechanism should be put in place as was done for prohibited investments.

8. Disproportionate Concerns

The Legislative Proposals indicate that the advantage rules will be extended to investment income where the income is tied to the existence of another investment, for example where two types of securities are offered, one inside a RRSP and one outside the RRSP where the total return is streamed disproportionately to the RRSP. The rules are vague and should be refined so that they only target disproportionate returns that arise because of the RRSP’s tax-deferred status (i.e., incorporate a purpose test like that in clause (b)(i)(B) of the existing advantage definition for TFSAs) where the disproportionate return “had as one of its main purposes to enable a person to benefit from the exemption from tax under Part I of any amount in respect of the RRSP”. That is, the existing TFSA rules apply if it is reasonable to consider, having regard to all the circumstances, that the increase in FMV of a particular property held in a RRSP is attributable, directly or indirectly to, a payment received as, on account or in lieu of, or in satisfaction of, a payment of interest, of a dividend, of rent, of a royalty or of any other return on investment, or of proceeds of disposition, in respect of property (other than property held in connection with the RRSP) held by a person who is, or who does not deal at arm's length with, the holder of the RRSP. For example, if a public corporation issues debt and shares, assuming the each investment bears a market rate of return and the debt is held in an annuitant's RRSP and the shares are held by the RRSP of the annuitant's spouse, given the vagueness of the existing TFSA language, the increase in the FMV of the shares may be considered to be indirectly attributable to the rate of interest payable on the indebtedness.

Recommendation

We recommend that the language be clarified so that only enhanced returns that are streamed to a RRSP or RRIF are caught.

9. Swap Transactions are Too Broad

An "advantage" and a "swap transaction" are broadly enough defined that any time a deferred plan buys or sells property (including for cash) from the annuitant or a person not dealing at arm's length with the annuitant, any subsequent income earned or gains realized in the plan from the property acquired by the plan could be subject to the 100% advantage tax (see, for example, 2011-0413291E5). The explanatory notes suggest the swap transaction definition is aimed at exploitations in the volatility of market prices.

As drafted, the rules still permit transfers of property between an annuitant and his or her plan, but then apply the 100% advantage tax unless they are contributions or distributions, or result in a refund of the 50% of fair market value tax (not applicable for existing investments). It is unclear what policy objective might be served by such a broad and punitive result. There are a large variety of legitimate circumstances where a transaction may occur that is described in the "swap transaction" definition but which are not abusive.

For example, we do not perceive a policy concern with an individual selling (or buying) shares in a public entity to (or from) his or her RRSP for cash rather than being forced to sell the investment in the public market to avoid brokerage fees or where the individual may be an insider of the corporation (such as a senior officer) subject to trading restrictions in the open market. As well, several financial institutions use swap transactions to put investments into an RRSP that are not cleared through an established market. This is necessary as they have set up their systems in such a way that a cheque cannot be issued from an RRSP. For such investments, an unregistered cash account is used to pay for the investment (creating an overdraft), and then the investment is swapped into the RRSP for cash to pay off the overdraft. If the swap is done at the same price at which the investment was purchased, then there is no abuse.

Recommendation

We recommend that all swaps be permitted unless there is some intent to avoid tax, and that in any event, we recommend that there be an exception for swaps that are purely administrative.

10. Unclear When and How Increases in Fair Market Value Are Measured

Paragraph (b) of the definition of an "advantage" refers to increases in the total fair market value of the property held in a deferred plan. However, the provision is silent as to when those increases are to be measured (i.e., at year-end, continuously, or otherwise). Moreover, it appears that this provision may require valuations of all property held within a plan (at year-end, continuously or otherwise), which likely is not very practical, especially for most private investments.

Recommendation

We recommend that paragraph (b) be clarified to provide that increases in value are only taken into account when they are realized, at least for investments that are not publicly-traded, and to further provide that measurement occurs at year-end.

11. RRSP Strip definition and coming-into-force provision

It is possible that an amount could be double counted under the RRSP strip definition. That is, it might not always be clear that the "amount obtained" by a controlling individual, as a result of a transaction or series of transactions one of the main purposes of which is to enable the person to obtain the benefit of property held by the RRSP, includes an "amount" referred to in paragraphs (a) to (c) at the end of the definition, even if it would appear to be inappropriate to consider it to be an RRSP strip. For example, consider a situation where $100 of RRSP property is used as security for a $125 personal borrowing by the annuitant. Subsection 146(10) would apply to include $100 in the income of the annuitant, but the preamble of the RRSP strip definition may include the entire $125 loan proceeds that are "used or obtained" by the annuitant. It is not clear that the $100 amount included in income under subsection 146(10) would reduce the RRSP strip to only $25, but in any event even a $25 RRSP strip appears inappropriate. Rather than the "amount used or obtained", it would appear preferable to contemplate the property of the RRSP that is used or the value of the benefit that is obtained. Furthermore, in the context of a secured loan transaction, there is no provision that would provide subsequent relief to the controlling individual following repayment of the loan, similar to the relief provided by subsection 146(7). There could also be situations where an amount obtained by the controlling individual or non-arm's length person is otherwise taxable under subdivision a or b of the Act, such that the RRSP strip amount would not be reduced and double tax would arise.

In the event that a property is acquired from an RRSP or RRIF (directly or indirectly) in exchange for consideration, but the circumstances technically result in an RRSP strip, it is not clear that the amount of the RRSP strip would be determined net of the value of the consideration provided. This should be clarified in the definition to avoid excessive amounts being treated as RRSP strips.

The coming-into-force provision indicates that the definition applies starting March 23, 2011. It is not clear whether it is intended that the definition could therefore apply to post-March 22nd increases in value of property (or property substituted therefor) that had been "swapped" out of an RRSP prior to March 23rd. In contrast to the coming-into-force provision for the definition of "swap transaction", there is no indication that it applies only in respect of transactions after March 22nd. Furthermore, no transitional relief is provided in a situation where a property is "swapped" out of an RRSP or RRIF in situations where the definition of "swap transaction" itself will not apply. As a result, it is possible that post-swap increases in value of property (or property substituted therefor) received by the individual or non-arm's length person in circumstances to which paragraph 64(6)(a) of the Legislative Proposals apply could result in an RRSP strip advantage tax, since it might be difficult to conclude that one of the main purposes of the property swap was not for the individual to "use or obtain the benefit" of the RRSP property (even where it is clear that "the main purpose" was simply to remove the property from the RRSP to avoid application of tax under Part XI.01).

Recommendation

We recommend that the definition of "RRSP strip" be amended to clarify that the amount is reduced by any amount described in existing paragraphs (a) to (d), or otherwise included in the income of the controlling individual or the non-arm's length person, where that amount arises in connection with the transaction or event or series of transactions or events mentioned in the preamble of the definition.

We also recommend that the coming-into-force provision be amended to provide that the definition applies only in respect of transactions after March 22, 2011, and that the definition should not apply in situations where it would otherwise apply solely because of a swap transaction to which paragraph 64(6)(a) of the Legislative Proposals applies. More generally, the definition should not apply at all in respect of swap transactions that are administrative in nature.

12. Technical issues with the definitions of "advantage" and "swap transactions"

We perceive certain further technical deficiencies in the definitions of an "advantage" and a "swap transaction" in subsection 207.01(1) and make the following recommendations.

Recommendation

- The reference to “income (including a capital gain)” in the proposals appears to be inconsistent with the general scheme of the Act and presumably should refer to income or a capital gain. We recommend the reference to “income (including a capital gain)” in subparagraph (c) of the definition of an "advantage" in subsection 207.01(1) be changed to "income or a capital gain".

- Clause (c)(i) of the definition of "advantage" in subsection 207.01(1) refers to “any other registered plan”. It is unclear what this is intended to achieve and whether it could be interpreted as, technically, resulting in multiple income inclusions, subject to subsection 248(28).

- It is not clear to us that the swap exclusion for dealing with a prohibited investment goes far enough to protect the new investment as it just refers to transferring a property out. We recommend that the rules be clarified so that the transfer of the replacement property into an RRSP or RRIF is also not a swap transaction.

13. Property becoming a Prohibited Investment

If an investment becomes a prohibited investment at a particular time (after March 22nd) there should be a deemed disposition and acquisition of the property at that time. Otherwise, the advantage rules will not work properly in connection with capital gains attributable to the investment. For example, a gain that accrued on the investment during a time when it was not a prohibited investment could be taxed in full as an advantage if the gain is realized subsequently, regardless as to whether the investment increases (or decreases) in value after the property becomes a prohibited investment (as long as a gain is ultimately realized).

Recommendation

We recommend that a deemed disposition and acquisition provision be added to ensure that gains accrued with respect to an investment held in an RRSP or RRIF before the investment in the registered plan becomes a prohibited investment are not subject to the advantage tax.

14. Liability of Issuers and Carriers

Proposed subsection 207.01(5) imposes an obligation on the "issuer" or "carrier" of a registered plan to exercise the care, diligence and skill of a reasonably prudent person to minimize the possibility that the trust governed by the registered plan hold a non-qualified investment. Further, pursuant to proposed subsection 207.05(3), if an advantage is extended by the "issuer" or "carrier" or by a person not dealing at arm's length with the "issuer" or "carrier", the "issuer" or "carrier" is liable to pay the tax.

Recommendation

To avoid uncertainty as to the scope of these obligations, we recommend that "issuer" and "carrier" be defined.

15. Definition of "Prohibited Investment"

The reference to "an interest in" in subparagraph (b) of the definition of a "prohibited investment" in subsection 207.01(1) should be clarified in the context of the subsequent reference to "an interest in … a corporation" in clause (b)(i). The "interest in" reference makes sense in the context of a partnership or a trust, but it unclear to us how this is meant to apply in the context of corporations.

Recommendation

We recommend that the "interest in" language in the definition of a "prohibited investment" in subsection 207.01(1) be clarified in the context of corporations.