June 2012

mcmillan tax bulletin

finance proposes amendments to the "prohibited investment" rules

In a recent letter (the "**Finance Letter**") to the Joint Committee of the Canadian Bar Association and the Canadian Institute of Chartered Accountants (the "**Joint Committee**"), the Department of Finance (Canada) ("**Finance**") announced its intention to recommend a number of technical amendments to the "prohibited investment" rules (the "**PI Rules**") in the *Income Tax Act* (Canada) that govern investments made by registered retirement savings plans ("**RRSPs**"), registered retirement income funds ("**RRIFs**") and tax-free savings accounts ("**TFSAs**", and collectively with RRSPs and RRIFs, "**Plans**").

Under the PI Rules, an annuitant under a Plan (a "**Plan Holder**"), which acquires and holds a "prohibited investment", may be subject to a 50% penalty tax on the fair market value of the investment and a 100% penalty tax on any income or gains derived from the investment.[1] The PI Rules are intended to discourage taxpayers from using Plans to generate improper tax advantages or engaging in abusive tax avoidance.

The PI Rules have been subject to criticism from a number of stakeholders, including the Joint Committee, in respect of

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[1] For a more detailed summary of the PI Rules, see Todd Miller, Michael Friedman and Carl Irvine, "The New RRSP/RRIF Anti-Avoidance Regime" 23(4) Taxation of Executive Compensation and Retirement 1463. For a high level overview of the PI Rules as they apply to RRSPs and RRIFs, see (i) our March 2011 client bulletin: "budget 2011: proposed changes target abuse of RRSPs and RRIFs", (ii) our September 2011 presentation "Navigating the New RRSP/RRIF Anti-Avoidance Rules", and (iii) our October 2011 client bulletin "further changes to the new RRSP/RRIF anti-avoidance rules". The foregoing publications describe the PI Rules announced or enacted as of the date of the respective publication and, therefore, may not reflect the current state of the law. Accordingly, readers are cautioned against exclusively referencing such material alone.

matters including the complexity and ambiguity of aspects of certain PI Rules and the related concern that the PI Rules will often apply to investments that do not generate any improper tax advantage. A number of the proposed amendments described in the Finance Letter appear to reflect an effort on the part of Finance to address some of these concerns.

definition of a "prohibited investment"

Likely the most important proposed change to the PI Rules is an amendment to narrow the scope of the statutory definition of a "prohibited investment". Under the current PI Rules, an investment in a particular corporation, trust or partnership (each, an "**Entity**") may be a "prohibited investment" for a Plan where the Plan Holder has a "significant interest"[2] in another Entity that does not deal at "arm's length" with the particular Entity (the "**Indirect Significant Interest Test**"). A common criticism of this test is that an investment in a particular Entity can be a "prohibited investment" for a Plan, notwithstanding that the Plan Holder's interest in the particular Entity is not significant. Moreover, the complexity of the Indirect Significant Interest Test means that a Plan Holder may have no way of knowing whether a particular investment is a "prohibited investment" for a Plan.

Finance appears to have recognized the validity of these concerns and is proposing to amend the definition of a "prohibited investment" to eliminate the Indirect Significant Interest Test. As a result, an investment in a particular Entity will generally only be a "prohibited investment" in circumstances where the Plan Holder has a "significant interest" in the particular Entity or does not deal at "arm's length" with the particular Entity. This is a welcome change and will provide relief for many taxpayers who would otherwise fall within the ambit of the PI Rules.

[2] Generally, a "significant interest" is represented by ownership by the Plan Holder or by persons not dealing at "arm's length" with the Plan Holder of 10% or more of a partnership or trust, or 10% of any particular class of shares of a corporation.

exclusion from the definition of a "prohibited investment"

In addition to amending the definition of a "prohibited investment", Finance is also proposing to introduce a safe-harbour from the application of the PI Rules by creating an exemption from the definition of a "prohibited investment". The proposed exemption will be available in respect of an investment in a particular Entity by a Plan that satisfies all of the following conditions:

1. Persons dealing at arm's length with the Plan Holder ("**Arm's Length Holders**") hold at least 90% of each of (i) the "equity value" (i.e., the fair market value of all shares of a corporation or interests in a trust or partnership), (ii) the total of the "equity value" and the outstanding debt, *and* (iii) the total votes associated with the "equity" (generally, shares or interests), of the particular Entity;

2. One or more Arm's Length Holders own "equity" ("**Similar Equity**") that has substantially similar terms and conditions as the investment held by the Plan, provided that, if all the Similar Equity held by Arm's Length Holders were held by one individual, that hypothetical individual would be a "specified shareholder" or "specified unitholder" of the Entity (which, in general terms, means that they would hold more than 10% of the Similar Equity);

3. The Plan Holder deals at "arm's length" with the Entity; and

4. None of the main purposes of the Plan Holder in the acquisition or holding of the investment by the Plan is to obtain an "advantage" (other than income or capital gains on the investment).

The safe-harbour is intended to exclude investments from the definition of a "prohibited investment" in circumstances where substantially similar investments are held by Arm's Length Holders and where there is no tax-avoidance purpose.

While this is a sensible change, the exemption may prove to be narrow in application in light of the conditions referenced in paragraphs (1) and (3) above. Since those conditions are (almost) the inverse of the tests contained in the definition of a "prohibited investment", in most circumstances, the aforementioned conditions will not be satisfied. The one clear circumstance in which the exemption might apply is where a Plan Holder has a "significant interest" in a corporation by virtue of holding 10% or more of the shares of one class of shares of the corporation, notwithstanding that such class of shares may not represent 10% of the total "equity value" or voting rights of the corporation.

While it is encouraging to see that Finance is attempting to reduce the scope of the "prohibited investment" definition, the proposed safe-harbour may only provide limited relief to taxpayers.

transitional rules for investment funds

In response to concerns that the initial investors in a newly-formed mutual fund trust or mutual fund corporation might naturally hold more than 10% of the units/shares of such a fund during the initial start-up period of the fund, the PI Rules contain a limited exclusion from the definition of a "prohibited investment" for units or shares of a "mutual fund trust" or "mutual fund corporation" during the first two taxation years of the particular fund, provided the fund is subject to, and substantially complies with, *National Instrument 81-102 Mutual Funds* of the Canadian Securities Administrators ("**NI 81-102**").

A common criticism of this exclusion was that it was unduly narrow in its application and did not capture a wide range of mutual funds that do not comply with NI 81-102. Finance appears to have addressed, in part, these criticisms by proposing to extend the exclusion to funds that are "registered investments" (that hold only "qualified investments" for the types of registered plans in respect of which they are registered), provided that such funds meet a basic diversification test and are not established with a tax avoidance objective. Finance is also proposing to provide a corresponding exclusion in respect of the winding-up of such mutual funds during the last two taxation years of such funds.

Unfortunately, as amended, this exclusion would still not capture a significant number of mutual funds available for purchase by Canadian investors that are not subject to, or are exempted from, NI 81-102. Moreover, the exclusion will only be available during the first and last two taxation years of a fund and, therefore, cannot be relied upon over an extended period of time.

other changes

In addition to the foregoing changes, Finance is also proposing a number of other amendments to the PI Rules, including:

- eliminating the current 2022 sunset date for the transitional rules applicable to "prohibited investments" acquired by RRSPs and RRIFs before March 23, 2011 (in effect, making the duration of the transitional period indefinite);
- clarifying some of the definitions in the related "advantage" rules applicable to Plans; and
- introducing a deemed disposition and reacquisition of property at the time immediately before such property becomes a "prohibited investment" (this change is presumably intended to ensure that Plan Holders are not subject to penalty tax in respect of appreciations in value that arose in respect of investments before they became "prohibited investments").

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These proposed amendments will generally have effect in respect of RRSPs and RRIFs after March 22, 2011 (i.e., will correspond with the time that the PI Rules first applied in respect of RRSPs/RRIFs). Finance has also said that, where relevant, these changes will also apply to TFSAs. Although it is not clear from the Finance Letter, it is hoped that any changes to the TFSA regime will be made effective as of January 1, 2009 (when the PI Rules for TFSAs first came into effect).

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a cautionary note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.