Building a better working world

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Avoiding penalties on registered plan investments

Overview

There are numerous registered savings programs available in Canada that provide significant tax benefits. These programs are designed to encourage retirement savings and provide retirement income (RRSP and RRIF), provide support for persons with disabilities (RDSP), encourage savings for post-secondary education (RESP) and promote savings for these or other purposes (TFSA).

While these programs can offer significant benefits to Canadians, there are several rules that are designed to prevent abuse of these programs to obtain a tax benefit beyond that intended by the program itself.

In this issue of *Wealth Insights*, we will look at the most common rules and discuss how to avoid penalties on investments held within these registered savings plans.

Advantage rules

What are the advantage rules and what is their purpose?

The advantage rules are a complex set of restrictions applicable to registered plans. Earlier versions of the current rules were introduced in 2009 coincident with the launch of the tax-free savings account (TFSA). The advantage rules were extended to replace previous limitations imposed on registered retirement savings plans (RRSPs) and expanded to include registered retirement income funds (RRIFs) in 2011. The rules were further extended to include registered disability savings plans (RDSPs) and registered education savings plans (RESPs) in 2017.

The purpose of the rules is to guard against transactions designed to artificially shift taxable income or to circumvent contribution limits. This is accomplished by discouraging transactions that would not normally occur absent these motivations.

What penalties are imposed under the advantage rules and who is liable for these penalties?

There are different types of advantages and these are described under "What is considered an advantage?" (below). Under the advantage rules, a penalty tax is imposed, and the amount of the tax is determined based on the type of advantage.

In the case of a benefit, the tax is equal to the fair market value of the benefit. In the case of a loan or indebtedness, the tax imposed is equal to the amount of that loan or indebtedness.

Where a registered plan strip occurs, the amount of the tax is equal to the amount of the strip.

Where penalties under the advantage rules are imposed, it is generally the controlling individual of a registered plan who is required to pay the penalties. A controlling individual includes:

- The holder of the TFSA or RDSP
- The annuitant of an RRSP or RRIF
- The subscriber of the RESP

However, if the advantage is extended by the issuer, carrier or promoter of the registered plan, or by a person not dealing at arm's length with them, then the issuer, carrier or promoter is liable to pay the tax.

To pay the tax, the controlling individual must file Form RC339, *Individual Return for Certain Taxes for RRSPs, RRIFs, RESPs or RDSPs*, or Form RC243, *Tax-Free Savings Account (TFSA) Return*. If the issuer, carrier or promoter must pay the tax, the relevant form is Form RC298, *Advantage Tax Return for RRSP, TFSA or RDSP Issuers, RESP Promoters or RRIF Carriers*. Both the return and the tax payable are due by June 30 of the year following the calendar year.

What is considered an advantage?

There are several different types of transactions that may give rise to an advantage and therefore be subject to penalties. In general terms, an advantage includes:

- A benefit, loan or indebtedness that is conditional on the existence of the registered plan, except as permitted[1]
- Transactions resulting in an increase in the fair market value of property in the registered plan that is attributable to any of the following:
  - Transactions that would not have occurred between arm's-length parties, and that were intended to take advantage of tax exemptions available to registered plans
  - Amounts received for services provided by the holder, annuitant or subscriber of the registered plan (or by a person not at arm's length with the holder, annuitant or subscriber)
  - Income received from or proceeds from property held by the holder, annuitant or subscriber of the registered plan (or by a person not at arm's length with the holder, annuitant or subscriber)
  - Swap transactions
- Income (including a capital gain) from prohibited investments
- Income (including a capital gain) attributable to deliberate overcontributions to a TFSA
- A registered plan strip

What is a swap transaction and why is it considered an advantage?

A swap transaction is a transaction that can be used to shift value out of or into a registered plan while avoiding the income tax inclusions on withdrawals or the limits on contributions. The advantage rules apply to swap transactions to prevent individuals from taking advantage of fluctuations in the market value of investments to shift value to or from the registered plan (e.g., from an RRSP to a TFSA) in order to avoid tax on any increase in this value.[2]

What is a prohibited investment and why is income from it considered an advantage?

Prohibited investments tend to involve non-arm's-length transactions, such as the ownership of shares of the capital stock of a corporation in which the controlling individual has a significant interest.

Prohibited investments include:

- Investments in, or the right to invest in, debt of the controlling individual of the registered plan
- Shares of, an interest in or debt of, or the right to acquire such an investment in, any of the following:
  - A corporation, partnership or trust in which the controlling individual has a significant interest (generally 10% or more)
  - A person or partnership that does not deal at arm's length with the controlling individual

Given the potential for inappropriately shifting value into or out of registered plans by the controlling individual, these investments are prohibited. See "What are non-qualified and prohibited investments and how do I avoid making them?" (below) for information on the penalty tax that applies when a registered plan holds a prohibited investment. As a further disincentive, any benefit generated from holding such an investment (i.e., the income or gains arising from it) is generally taxed as an advantage.[3]

[1] Among the permitted exclusions are benefits from the provision of administrative or investment services, a loan or indebtedness subject to arm's-length terms, ordinary payments and withdrawals out of the registered plan to the beneficiary or controlling individual, and certain promotional incentives that are offered broadly in a normal commercial context.

[2] Special transitional rules may allow swap transactions in certain limited situations where a registered plan holds a prohibited or non-qualified investment.

[3] If an election was filed, special rules allow prohibited investments that were held by an RRSP or RRIF on March 23, 2011, to benefit from transitional relief, allowing income and gains earned or accrued after March 22, 2011, not to be subject to the tax on advantages.

What is a registered plan strip?

A registered plan strip, which does not apply to TFSAs, occurs when a transaction or event (or series of transactions or events) reduces the fair market value of property held in a registered plan and one of the main purposes of the transaction or event is to enable the controlling individual (or a person who does not deal at arm's length with the controlling individual) to obtain a benefit as a result of the reduction.

The advantage rules for registered plan strips are intended to prevent transactions that extract amounts from a registered plan on a tax-free basis. For example, without these rules, an individual could repeatedly transfer publicly traded shares between their RRSP and TFSA, taking advantage of stock market fluctuations to shift value from their RRSP to their TFSA, and withdraw the extra value from their TFSA on a tax-free basis. In this example, the increase in the value of the TFSA may also be subject to the advantage tax rules, as the increase in the value of the TFSA results in a swap transaction.

There are some transfers between registered plans that are specifically permitted and would not be considered registered plan strips. Examples include:

- Ordinary withdrawals from registered plans
- Amounts withdrawn from an RRSP under the Home Buyers' Plan or Lifelong Learning Plan
- Permitted transfers between RRSPs and RRIFs, or from an RRSP or RRIF to a registered pension plan or pooled registered pension plan
- A refund of payments made under a RESP
- The non-taxable portion of disability assistance payments from an RDSP

How do I avoid triggering the advantage rules?

The advantage rules are very complicated, and it is easy to inadvertently become subject to them. To reduce the possibility of having the advantage rules apply, you should consider the following:

1. Exercise caution in making transfers involving different plan types.
2. Ensure the terms of all transactions, investments and services involving registered plans reflect arm's-length values.
3. Avoid self-dealing with your registered plans.
4. If an opportunity involving your registered plans appears too good to be true, it may indicate the existence of a potential violation of the advantage rules.

If you are uncertain whether the advantage rules apply in a particular situation, and for complex transactions or transactions involving investments in entities you have other interests in, consider seeking appropriate tax advice before you undertake a transaction.

What are non-qualified and prohibited investments and how do I avoid making them?

All registered plans have restrictions on the types of investments they may acquire. If a registered plan acquires a non-qualified or prohibited investment, or if a previous investment becomes a non-qualified or prohibited investment, it will be subject to a special tax equal to 50% of the fair market value of the property at the time it was acquired or became non-qualified (or prohibited).

To pay the tax, the controlling individual must file Form RC339, *Individual Return for Certain Taxes for RRSPs, RRIFs, RESPs or RDSPs*.

In addition to the 50% tax described above, the controlling individual may also be subject to the advantage tax on income earned and capital gains realized on prohibited investments. Similarly, if an individual receives a notice from the Canada Revenue Agency (CRA) requiring income earned on non-qualified investments to be paid out of a registered plan, and the amount is not paid out within 90 days, the amount is treated as an advantage and is subject to the advantage tax.

If an investment is both non-qualified and prohibited, it is treated as a prohibited investment only.

We discussed prohibited investments when considering the advantage rules earlier in this article. Please see that discussion for further information.

A non-qualified investment is simply one that is not a qualified investment. A qualified investment includes but is not limited to:

- Cash
- Guaranteed investment certificates (GICs)
- Government and corporate bonds
- Securities listed on a designated stock exchange
- Mutual funds
- Insured mortgages

The tax may be refundable in certain circumstances. If the non-qualified or prohibited investment is disposed of, or ceases to be a non-qualified or prohibited investment, before the end of the calendar year following the year in which it was acquired or became non-qualified or prohibited, you can apply for a refund by sending a written request along with Form RC339 to the CRA.

The written request should include the name and description of the property, the number of shares or units held, the date the property was acquired or became non-qualified or prohibited, and the date of disposition or the date the property became qualified or ceased to be prohibited. However, if it is reasonable to consider that you knew (or should have known) that the property was or would become prohibited or non-qualifying, you will not be entitled to a refund.

How can I keep a close watch on contribution limits and avoid overcontributions?

All registered plans have limits on the amount of money that can be contributed to the plan. If overcontributions occur, penalties may be applicable. So, it is important that you monitor your contributions and contribution room carefully.

RRSPs and TFSAs

Recognizing that inadvertent overcontributions can occur, there is an overcontribution margin of $2,000 currently available for RRSPs. Excess RRSP contributions beyond this amount are subject to a penalty tax equal to 1% per month on excess contributions until the excess is removed from the plan.[4]

In the case of a TFSA, a similar 1% per month penalty tax is payable on excess contributions, although no overcontribution margin exists for TFSAs. A penalty tax is also applicable on income or capital gains deriving from deliberate overcontributions. If it is determined that you deliberately overcontributed to your TFSA, the income or gain from the overcontribution may be considered an advantage and subject to a 100% tax.[5]

The CRA provides some assistance to holders of TFSAs and RRSPs in monitoring contributions and contribution room. RRSP contribution limits are provided on your annual notice of assessment issued by the CRA after you file your personal income tax return. For TFSAs, this information is not included on the notice of assessment but is available online.

To assist in tracking available contribution room, consider signing up for the My Account service from the CRA. This will allow you to receive assessments and reassessments, submit documents and receive statements of account online.

For more information, visit the CRA website at www.canada.ca/en/revenue-agency/services/e-services/cra-login-services.html.

RESPs

Excess contributions to an RESP on behalf of a beneficiary are also subject to a penalty of 1% per month on any excess contributions until they are withdrawn. It may be difficult for you to know whether excess contributions have occurred, particularly if other interested parties (such as grandparents) have contributed to an RESP on behalf of your children without your knowledge.

If you think this may have occurred or be occurring, it is important to talk to potential contributors to confirm whether excess contributions have been made. If they have, you should calculate the tax, file the necessary return, and arrange to withdraw the excess contributions immediately.[6]

The CRA does have some ability to waive or cancel part of the taxes for RESP overcontributions if, in its view, it is appropriate to do so after reviewing your case. To obtain the necessary returns and for instructions on how to apply for a waiver of the penalty taxes, please see the following CRA website:

www.canada.ca/en/revenue-agency/services/tax/individuals/topics/registered-education-savings-plans-resps/resp-contributions/tax-on-resp-excess-contributions.html.

RDSPs

Overcontributions to an RDSP generally do not occur. This is because the issuer of the plan is required to limit contributions to the maximum lifetime contribution limit as a condition of registering the plan with the CRA.

Conclusion

With careful planning, registered plans provide significant tax benefits and incentives to plan for retirement or other savings needs. Paying attention to the investments you are making and the amounts you are contributing before undertaking these transactions can avoid costly mistakes.

[4] Individuals must file Form T1-OVP, *Individual Tax Return for RRSP, PRPP and SPP Excess Contributions*, to report the tax payable on RRSP overcontributions.

[5] Individuals must file Form RC243, *Tax-Free Savings Account (TFSA) Return*, to report the tax payable on excess TFSA contributions and on an advantage in respect of a TFSA.

[6] Individuals must file Form T1E-OVP, *Individual Tax Return for RESP Excess Contributions*, to report the tax payable on RESP overcontributions.

Learn more

For more information on this and any other topics that may be of concern, please contact your EY or EY Law advisor or one of the following professionals:

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