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RRSP Investments in Public Companies

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A registered retirement savings plan (RRSP) is an important financial planning tool that allows the annuitant and his or her spouse or common-law partner to set aside part of their income each year to save for retirement on a pre-tax basis by deducting the amount contributed to the RRSP each year from their current taxable income, up to the annual contribution limit. The earnings on assets held in an RRSP accumulate tax-free, and the RRSP funds are only taxed when they are withdrawn. While the deadline for RRSP contributions for the 2015 tax year was February 29, 2016, RRSP contributions and associated tax planning for 2016 can start now.

An RRSP can hold any type of investment, but the annuitant should restrict RRSP investments to qualified investments to avoid the adverse tax consequences associated with the RRSP holding prohibited investments. A wide range of investments qualify, including shares of a corporation listed on a designated stock exchange, such as the Canadian National Stock Exchange, Montreal Exchange, TSX Venture Exchange, and Toronto Stock Exchange.

If an annuitant has unused RRSP contribution room, contributing shares of a public corporation can be an attractive option. The value of the shares contributed can be deducted from the annuitant’s taxable income (up to the annual contribution limit) and any gains will be compounded tax-free as long as the shares remain in the RRSP. An annuitant can also contribute shares of a public corporation that he or she already owns. While the shares will be deemed to have been sold at fair market value for tax purposes (and therefore a capital gain may be realized), as long as the funds are left in the RRSP for many years, the advantages of deduction and tax-free compounding can likely outweigh any capital gain.

Significant changes to the *Income Tax Act* in the 2011 federal budget introduced the concept of a “prohibited investment” for RRSPs, aligning the rules for RRSPs with those enforced on tax-free savings accounts. An investment is generally considered a prohibited investment if the annuitant alone, or together with non-arm’s length persons, owns more than 10% of the issued shares of the corporation or does not deal at arm’s length with the corporation. A right to acquire more than 10% of the issued shares of a corporation also constitutes a prohibited investment. Whether an investment is prohibited is examined throughout the period of ownership: a future acquisition could result in a qualified investment becoming prohibited if, as a result of the acquisition, the annuitant then owns, directly or indirectly, more than 10% of the issued shares of the corporation. It is important that RRSP investments are consistently monitored to ensure that the RRSP does not hold prohibited investments.

If an RRSP holds a prohibited investment, two tax consequences may be imposed on the annuitant:

1. A 50% penalty tax on the fair market value of the investment at the time it was acquired or became a prohibited investment; and
2. A 100% tax on income earned or capital gains realized from the prohibited investment.

The potential for shares of a private corporation to constitute a qualified investment has also been restricted. These more complex rules will be the subject of our next tax article.