IIAC ACCVM
Investment Industry Association of Canada Association canadienne du commerce des valeurs mobilières

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Qualified Investment Consultation
c/o Director General, Tax Legislation Division
Department of Finance Canada
90 Elgin Street
Ottawa ON K1A 0G5

**Delivered via Email to QI-consultation-PA@fin.gc.ca**

Dear Sirs/Mesdames:

## RE: BUDGET 2024 - CONSULTATION ON QUALIFIED INVESTMENTS FOR REGISTERED PLANS

The Investment Industry Association of Canada (the "**IIAC**") is Canada's national association representing investment firms that provide products and services to Canadians. The IIAC is submitting various proposals and considerations for amendments to the *Income Tax Act*[1] (the "**Tax Act**") and the *Income Tax Regulations*[2] (the "**Tax Regulations**"). The IIAC represents investment firms of every type including investment and mutual fund dealers, exempt market dealers, portfolio managers and investment fund managers. The IIAC's members are involved with registered plans[3] in various capacities and contexts, and they are therefore impacted by the administration of the qualified investment ("**QI**")[4] rules that determine which assets registered plans can and cannot invest in.

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[1] RSC 1985, c 1 (5th Supp).

[2] CRC, c 945.

[3] Throughout this letter, the term "registered plan" refers to any one or more of a: Registered Retirement Savings Plan in section 146 of the Tax Act ("**RRSP**"); Registered Retirement Income Fund in section 146.3 of the Tax Act ("**RRIF**"); Tax-Free Savings Account in section 146.2 of the Tax Act (**"TFSA"**); Registered Education Savings Plan in section 146.1 of the Tax Act ("**RESP**"); Registered Disability Savings Plan in section 146.4 of the Tax Act ("**RDSP**"); Tax-Free First Home Savings Account in section 146.6 of the Tax Act ("**FHSA**"); and Deferred Profit Sharing Plan in Part X of the Tax Act ("**DPSP**").

[4] Throughout this letter, the assets held by a registered plan are either referred to as "**QIs**" (*i.e.,* assets that are QIs) or "**non-QIs**" (*i.e.,* assets that are not QIs).

Thank you for the opportunity to participate in the Budget 2024 consultation on how the QI rules could be modernized on a prospective basis to improve the clarity and coherence of the registered plans regime (the "**QI Consultation**").

This letter is the IIAC's submissions in response to the QI Consultation. In this regard, the IIAC makes the following submissions:

1. Registered plans should be permitted to loan QIs pursuant to a fully paid securities lending ("**FPL**") program, provided that the FPL transaction (i) qualifies as a "securities lending arrangement," as defined in subsection 260(1) of the Tax Act and (ii) the registered plan is afforded protections, in its capacity as securities lender, that are equivalent or superior to those in rule 4600 of the *Investment Dealer and Partially Consolidated (IDPC) Rules*.
2. In situations where the registered plan issuer took reasonable steps to ensure that the particular asset was a QI at the time the registered plan acquired the asset, the registered plan issuer should not be liable for any of the registered plan's interest, penalties or taxes from holding a non-QI if either (i) the asset is in actuality a non-QI despite the registered plan issuer's reasonable steps or (ii) the asset ceases to be a QI, and becomes a non-QI, at any time while it is held by the registered plan.
3. The compliance regime for holding shares of small businesses in registered plans should be simplified by:
    a. Harmonizing the requirements for whether a share of a small business is a QI across all types of registered plans;[5] and
    b. Obligating the small business corporation to provide registered plan issuers or holders with the fair market value of the small business shares, in order for registered plan issuers to meet their tax compliance obligations.
4. Other requests, being:
    a. Simplifying the list of designated stock exchanges for multi-tiered or multi-segmented exchanges; and
    b. Classifying all derivatives that trade on a designated stock exchange as QIs.

Please see below for the details relating to each of the IIAC's submissions.

## 1) FPL Transactions by Registered Plans

### Request: Permitting Registered Plans to Engage in FPL Transactions

Registered plans should be permitted to loan QIs to securities borrowers in order for the registered plan to earn additional passive income (i.e, borrow fees).

[5] This specifically addresses the QI Consultation's question on "how the rules relating to investments in small businesses could be harmonized to apply consistently to all registered savings plans".

In an FPL (commonly referred to as a "fully paid securities lending") transaction, a securities dealer facilitates, in exchange for a fee, loans of securities in the first instance between the following two parties:

1. The securities dealer's client (the "**FPL Lender**") who has fully paid securities[6] that are QIs that they wish to loan (the "**FPL Securities**"); and
2. A borrower (the "**FPL Borrower**") who wishes to borrow the FPL Securities.

Generally, the FPL Borrower then loans the FPL Securities to third-party financial institutions in return for collateral consisting of cash. During the term of the loan, the FPL Lender has a right to obtain a return of the borrowed securities or securities that are identical to the borrowed securities, and a right to receive from the FPL Borrower amounts as compensation for any distributions on the borrowed securities that would have otherwise been received by the FPL Lender. Importantly, the FPL's risk of loss and opportunity for gain or profit in respect of the borrowed securities is not changed as a result of fully paid securities lending.

Allowing registered plans to engage in FPL transactions by acting as the FPL Lender would permit the registered plans to earn additional passive income (i.e., borrow fees), and the government to collect more tax revenues upon withdrawal on the QIs held by the registered plan.

## Policy Rationales: Why FPL Transactions Should be Permitted for Registered Plans

### Additional Income for the Registered Plan with Minimal Risk

In an FPL transaction, the FPL Lender earns passive income in respect of its FPL Securities (which are fully paid securities of the FPL Lender). Accordingly, in an FPL transaction, the FPL Lender is lending FPL Securities that it owns outright. To compensate the FPL Lender for lending out its securities, the FPL Lender earns passive income in the form of a borrow fee for making the loan.

In order to earn this passive income, the FPL Lender is afforded various protections by securities law and regulatory requirements. Examples of such protections, including those provided to the FPL Lender under rule 4600 of the *Investment Dealer and Partially Consolidated (IDPC) Rules* ("**CIRO Rule 4600**"), are the following:

- The FPL Lender can recall the FPL Securities from the FPL Borrower at any time;
- The securities dealer holds, for the FPL Lender, collateral having a value at least equal to the full value of the FPL Security. This collateral is held by the dealer in trust (the "**Collateral Trust**") for the FPL Lenders in a separate account.[7] Accordingly, in the event of a default on the securities loan (*e.g.,* the securities dealer does not return the FPL Securities when the securities loan becomes due or upon request by the FPL Lender), then the FPL Lender retains the collateral, which consists of cash, except for in exceptional circumstances, where the collateral returned could consist of other qualified securities. In the context of FPL transactions within registered

[6] While CIRO Rule 4600 permits FPL transactions in margin accounts, FPL transactions in margin accounts are not applicable to registered plans as registered plans generally have borrowing restrictions. As a result, FPL transactions in margin accounts are not considered for this submission.

[7] Canadian Investment Regulatory Organization, "Guidance on fully paid securities lending", online: https://www.ciro.ca/news-room/publications/guidance-fully-paid-securities-lending#toc-2-5-collateral at 1.3.

plans, the dealers can structure the Collateral Trusts to only hold cash or other QIs to ensure that the registered plan at no point holds a non-QI in the event of a default of the securities loan;

- The collateral is required to be segregated;
- The value of the collateral is marked-to-market daily to ensure that the value of such collateral is at all times is equal to or greater than (and in the case of U.S. securities, at least 102%) of the full value of the FPL Securities;[8] and
- The collateral is highly liquid (usually in the form of cash[9]).

In addition, there are a number of proposed changes to CIRO's FPL rules, including amendments which "enhance the rule framework regarding retail [FPL programs]."[10] Some of these amendments will increase the safeguards provided to FPL Lenders.

In short, FPL transactions provides a FPL Lender with an additional passive income opportunity from lending its FPL Securities, while simultaneously ensuring the FPL Lender has significant protections from the risks of engaging in such FPL transactions (through the above-mentioned securities laws and regulatory requirements governing securities dealers that engage in FPL).

### Potential Outcomes of FPL Transaction for Registered Plan: Return of Securities or Cash

When a registered plan acts as the FPL Lender, there are only two results for the registered plan:

1. The registered plan receives the FPL Security or identical securities (which are a QIs) in return; or
2. There is a default under the securities loan, thereby causing the FPL Lender to realize on the highly liquid collateral that secures the securities loan. The collateral is generally cash (which is a QI), or in exceptional circumstances, will be a security that is also a QI.

Accordingly, for the registered plan (*i.e.,* the FPL Lender) that engages in an FPL transaction, the end result is that the registered plan will only hold QIs. Specifically, the only possible results for a registered plan that engages in an FPL transaction is that the registered plan will hold either the security that it lent or the collateral (*i.e.,* if there is a default under the securities loan), both of which will be QIs.

### Economic Realities Should Match Tax Consequences

The economic reality of a securities lending transaction (such as an FPL transaction where a registered plan is the FPL Lender) is that, despite loaning the FPL Security, the FPL Lender is in the same economic position in respect of the FPL Security. This is because the FPL Lender retains all, or substantially all, of the economic risks and benefits associated with the lent securities, since:

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[8] Canadian Regulatory Investment Organization, *Corporation Investment Dealer and Partially Consolidated Rules* (27 May 2024) at s 4603(1)(i) [*CIRO Rules*].

[9] Per the CIRO guidance, under CIRO Rule 4600, the collateral held within the Collateral Trust is restricted to cash collateral in consideration of investor protection concerns. However, in exceptional circumstances, the use of qualified securities may be permitted as collateral only when CIRO is satisfied the FPL Lender' interests are not compromised (see *CIRO Rules* at s 4624(2)).

[10] Canadian Regulatory Investment Organization, "Proposed rule amendments — Fully paid securities lending and financing arrangements" (15 February 2024), online: https://www.ciro.ca/news-room/publications/proposed-rule-amendments-fully-paid-securities-lending-and-financing-arrangements#footnote8_19ckn76 at 7.1.

- The FPL Borrower is obligated to return the FPL Security or an identical security; and
- The FPL Borrower receives compensation payments that replicate the amount of any distributions the FPL Borrower would have received on the FPL Securities.

The Tax Act has already recognized this economic reality for a securities lending arrangement. For example, subsection 260(2) of the Tax Act provides that where a person (such as the FPL Lender) has transferred a security (such as the FPL Securities) under a "securities lending arrangement," the person is deemed to have not disposed of the security and instead the security is deemed to continue to be the property of the lender. In the explanatory notes to this provision, the Department of Finance stated that subsection 260(2) of the Tax Act "recognizes that the lender continues to bear the capital risk associated with the security and [subsection 260(2)] is designed to prevent an inappropriate recognition of a gain or loss in respect of the security."[11]

In other words, subsection 260(2) of the Tax Act already recognizes that when the FPL Lender loans the FPL Security to the FPL Borrower, the FPL Lender continues to be in the same economic position in respect of the FPL Security such that it is inappropriate to impose tax on the FPL Lender in respect of the FPL transaction. The economics of securities lending for the FPL Lender should continue to apply even if the FPL Lender is a registered plan. Ensuring that registered plans do not face adverse tax consequences when engaging in FPL transactions would be consistent with the Department of Finance's existing acknowledgement of the economic realities of securities lending.

## Allowing All Canadians to Benefit from FPL

It is important that the government ensures that the tax system provides fairness to all Canadians seeking to save and invest their money, regardless of whether such actions occur within a registered account or non-registered account.

The inability for Canadians to engage in FPL transactions within registered plans can cause unfair economic opportunities between lower income earners (who generally invest in their registered accounts only) and higher income earners (who generally have non-registered accounts that may enter into FPL transactions). In other words, the arbitrary distinction on the permissibility of FPL transactions in registered versus non-registered accounts puts lower income Canadians at a disadvantage by restricting their ability to earn additional passive income.

This arbitrary distinction is also evident when looking at the impact on younger Canadians. Younger Canadians are less likely than their parents to be enrolled in a workplace pension plan and the average age of home ownership – traditionally Canadians' largest tax-sheltered investment vehicle – continues to increase. As FPL transactions provide a source of additional passive income, they can increase savings for younger Canadians. Since the majority of younger Canadians do not hold investments outside of registered accounts, they can only earn passive income from FPL transactions in their registered plans. Accordingly, by permitting FPL transactions in registered plans, this would increase younger Canadians' ability to save and invest (which is consistent with Budget 2024's theme of "unlocking the door to the middle class for millions of younger Canadians"[12]).

[11] Department of Finance, *Technical Notes to the Income Tax Act* (June 1989), at s 260(2).
[12] Department of Finance, *Budget 2024: Fairness for Every Generation* (16 April 2024) at ii.

Given the strong policy reasons in support of FPL transactions by registered plans (see above), the arbitrary distinction should be removed. This arbitrary distinction creates a neutrality issue that is not supported by any strong tax or non-tax policy rationales; in fact, as shown above, there are stronger policy arguments supporting FPL transactions by registered plans.

## Proposed Solution: Amending the Tax Regulations to Permit FPL Transactions by Registered Plans

Under the current rules in the Tax Act and the Tax Regulations, there is some uncertainty as to whether registered plans can engage in FPL transactions. In particular, the CRA may take the view that registered plans engaging in FPL transactions acquire non-QIs in the course of the FPL transaction. This potential issue is explained further below.

When a registered plan lends an FPL Security that it owns, the CRA may take the view that the registered plan acquired certain rights (collectively referred to as the "**Bundle of Rights**") in the FPL transaction. The Bundle of Rights can include, but is not limited to, the following:

- The right of the FPL Lender to receive the FPL Security or an identical security in return, a right which it may exercise at any time;
- The right of the FPL Lender to receive dividend compensation payments that any distributions on the FPL Securities that the FPL Lender would otherwise receive if it did not loan the FPL Security and a borrow fee for the loan of the FPL Security; and
- The right the FPL Lender has in the Collateral Trust.

The CRA may take the view that the Bundle of Rights is not captured by the list of QIs under the current provisions of the Tax Act or Tax Regulations, and, accordingly, that registered plans acquire non-QI (*i.e.,* the Bundle of Rights) in the course of FPL transactions (thereby triggering adverse tax consequences for those registered plans).

In order to remove any uncertainty regarding whether FPL transactions may be undertaken by registered plans, the IIAC recommends the Department of Finance introduce proposed new paragraph 4900(1)(x) of the Tax Regulations to add the Bundle of Rights as a QI for registered plans:

> **4900 (1)** For the purposes of paragraph (d) of the definition *qualified investment* in subsection 146(1) of the Act, paragraph (e) of the definition *qualified investment* in subsection 146.1(1) of the Act, paragraph (c) of the definition *qualified investment* in subsection 146.3(1) of the Act, paragraph (d) of the definition *qualified investment* in subsection 146.4(1) of the Act, paragraph (h) of the definition *qualified investment* in section 204 of the Act and paragraph (c) of the definition *qualified investment* in subsection 207.01(1) of the Act, each of the following investments is prescribed as a qualified investment for a plan trust at a particular time if at that time it is
>
> > **[…]**
> >
> > **(x)** any right of a securities lender in respect of a securities lending arrangement (as defined in subsection 260(1) of the Act), provided that the securities lender has the protections that are equal to, or better than, those in rule 4600 of the *Investment Dealer and Partially Consolidated (IDPC) Rules*

There are three notable features of the IIAC's language for proposed new paragraph 4900(1)(x) of the Tax Regulations:

- "*Any* right" in relation to the FLP transaction is a QI based on the proposed language. The reason for keeping this proposed language so broad is that the Bundle of Rights encompasses many different rights that are difficult to exhaustively describe. For example, the Bundle of Rights includes certain rights that the FPL Lender has in relationship to the FPL Borrower (such as the FPL Lender's right to compensation payments for distributions on the FPL Securities), in addition to certain rights the FPL Lender has in the Collateral Trust. The use of the broad phrase "*any* right" is designed to capture all such rights that may be acquired by the registered plan (as FPL Lender) in an FPL transaction.
- In order for the FPL transaction to be permissible for a registered plan, the transaction must meet the securities lending requirements in section 260 of the Tax Act by requiring the FPL transaction to meet the definition of "securities lending arrangement" in subsection 260(1) of the Tax Act. One of the consequences of this is that an FPL transaction will only benefit from proposed new paragraph 4900(1)(x) if the FPL Security is both a QI (for purposes of the QI rules) <u>and</u> a "qualified security" (as defined in subsection 260(1) of the Tax Act).
- To ensure that registered plans engaging in FPL transactions are afforded the protections described above, the proposed draft legislation will only permit registered plans to engage in FPL transactions if the terms of the transaction provide the registered plan with protections that are either equivalent to, or superior than, those provided for in CIRO Rule 4600.

## 2) Trustee Liability for a Registered Plan that Holds Non-QI

### **Request:** Limiting the Trustee's Liability in Appropriate Circumstances

When a registered plan holds a non-QI, the registered plan may be subject to taxes, interest and penalties under the Tax Act. For trusteed registered plans, the trustee of the trust (*i.e.,* the registered plan issuer) may be liable for such amounts where the registered plan has insufficient assets to pay the amounts.

The IIAC requests that registered plan issuers should not be liable for the registered plan's taxes, interest and penalties from holding a non-QI in situations where the registered plan issuer took reasonable steps to confirm that the particular asset was a QI at the time the registered plan acquired the asset.

### **Policy Rationale:** Unfairness with Imposing Liability on the Registered Plan Issuer

In certain situations, the registered plan issuer may have no ability to control whether a registered plan holds a non-QI. In such situations, the registered plan issuer should not be liable for the registered plan's interest, penalties and taxes for holding a non-QI, since the registered plan issuer could not have reasonably prevented the registered plan from acquiring the non-QI (thus the registered plan issuer could not have prevented the adverse tax consequences for the registered plan from holding the non-QI).

Examples of situations where it would be unfair to make the registered plan issuer liable for the registered plan's interest, penalties and taxes from holding a non-QI, include:

- *Shares of a Canadian-Resident Corporation that are Delisted from a Designated Stock Exchange* – Shares of a Canadian-resident corporation that are listed on a designated stock exchange are a QI.[13] When the shares of a Canadian-resident corporation become delisted, such shares generally continue to be a QI on the basis that the corporation continues to be a "public corporation" for purposes of the Tax Act[14]. However, there are instances where a delisted Canadian-resident corporation ceases to be a "public corporation" for purposes of the Tax Act (for example, if the corporation files an election with the CRA to be treated as a non-public corporation for purposes of the Tax Act).[15] Whether or not a delisted Canadian-resident corporation makes this election is generally unknown to the registered plan issuer, and there is currently no publicly searchable list of corporations that are "public corporations" for purposes of the Tax Act. Accordingly, there are instances whereby a delisted Canadian-resident corporation loses "public corporation" status (thereby causing the shares of the corporation to become non-QIs) that are wholly outside of the registered plan issuer's control and knowledge, thus it is unfair to make the registered plan issuer liable for the registered plan's amounts owing in these circumstances.
- *Shares of a Non-Resident Corporation that are Delisted from a Designated Stock Exchange* – Shares of non-resident corporation that are listed on a designated stock exchange are a QI for registered plans.[16] When the shares of a non-resident corporation become delisted from the designated stock exchange, such shares generally cease to be a QI. In these situations, the registered plan issuer would have taken all reasonable steps to ensure the shares were a QI at the time the registered plan acquired the shares (*i.e.,* by ensuring the shares were listed on a designated stock exchange), but the registered plan issuer has no control over the non-resident

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[13] See paragraph (a) of the definition of "qualified investment" in subsection 146(1) of the Tax Act for **RRSPs**; paragraph (a) of the definition of "qualified investment" in subsection 146.3(1) of the Tax Act for **RRIFs**; paragraph (a) of the definition of "qualified investment" in subsection 207.01(1) of the Tax Act for **TFSAs**; paragraph (a) of the definition of "qualified investment" in subsection 146.1(1) of the Tax Act for **RESPs**; paragraph (a) of the definition of "qualified investment" in subsection 146.4(1) of the Tax Act for **RDSPs**; paragraph (a) of the definition of "qualified investment" in subsection 207.01(1) of the Tax Act for **FHSAs**; and paragraph (d) of the definition of "qualified investment" in section 204 of the Tax Act for **DPSPs**.

[14] Paragraph 4900(1)(b) of the Tax Regulations provides that a share of a "public corporation" other than a mortgage investment corporation are a QI.

[15] Pursuant to paragraphs (a) and (c) of the definition of "public corporation" in subsection 89(1) of the Tax Act, once a Canadian-resident corporation becomes delisted from a designated stock exchange, the Canadian-resident corporation will continue to be a "public corporation" for purposes of the Tax Act, *unless* (i) the Canadian-resident corporation elects not to be a "public corporation" or (ii) the Minister of National Revenue designates the company to not be a "public corporation".

[16] See paragraph (a) of the definition of "qualified investment" in subsection 146(1) of the Tax Act for **RRSPs**; paragraph (a) of the definition of "qualified investment" in subsection 146.3(1) of the Tax Act for **RRIFs**; paragraph (a) of the definition of "qualified investment" in subsection 207.01(1) of the Tax Act for **TFSAs**; paragraph (a) of the definition of "qualified investment" in subsection 146.1(1) of the Tax Act for **RESPs**; paragraph (a) of the definition of "qualified investment" in subsection 146.4(1) of the Tax Act for **RDSPs**; paragraph (a) of the definition of "qualified investment" in subsection 207.01(1) of the Tax Act for **FHSAs**; and paragraph (d) of the definition of "qualified investment" in section 204 of the Tax Act for **DPSPs**.

corporation becoming delisted and the shares of the non-resident corporation becoming a non-QI.

- *Shares of a Specified Small Business Corporation* – In accordance with subsection 4900(14) of the Tax Regulations, shares of a "specified small business corporation" are QIs for FHSAs, RESPs, RRIFs, RRSPs and TFSAs. In order for a corporation to be a "specified small business corporation" as defined in subsection 4901(2) of the Tax Regulations, all or substantially all of the FMV of the corporation's assets must be attributable to assets that are (i) used principally in an active business carried on primarily in Canada by the corporation or by a corporation related to it and/or (ii) shares or debt of connected small business corporations. The registered plan issuer has no ability to verify whether the corporation's asset values meet the foregoing test, and will therefore need to rely on opinions or representations provided by the corporation or its advisors. Since the only way for the registered plan issuer to confirm whether the corporation is a "specified small business corporation" is to rely on a third-party, the registered plan issuer should not be liable for the registered plan's interest, penalties or taxes if the third-party incorrectly advised the registered plan issuer on whether the corporation meets the "specified small business corporation" requirements.
- *Units in a Trust that Loses Mutual Fund Trust Status* – In accordance with paragraph 4900(1)(d) of the Tax Regulations, units of a "mutual fund trust" are QI for registered plans. An investment fund trust may cease to be a "mutual fund trust" for various reasons (such as if the investment fund trust fails to meet the dispersal of ownership requirements in paragraph 132(6)(c) of the Tax Act and paragraph 4801(b) of the Tax Regulations). If the trust ceases to be a "mutual fund trust" and the units are not a "registered investment" for purposes of subsection 4900(5) of the Tax Regulations, then the units become a non-QI. The registered plan issuer has no control over the circumstances which caused the units to cease to become a QI and may even be unaware if the QI loses its "mutual fund trust" status.

Accordingly, the registered plan issuer should not be held liable for the registered plan's liabilities under the Tax Act for holding a non-QI in certain circumstances (such as those described above), specifically where the registered plan took reasonable steps to confirm whether the assets were a QI or a non-QI at the time of acquisition.

## Proposed Solution: Amending the Tax Act Provisions on the Liability of Registered Plan Issuers

In order to prevent registered plan issuers from being liable for the registered plan's interest, penalties and taxes from holding a non-QI in appropriate circumstances, the Department of Finance may enact a new provision that expressly limits the registered plan issuer's liability for amounts owing by the registered plan. This provision would encourage businesses to continue to offer their services as registered plan trustees, thus ensuring the continued viability of the registered plan investment regime.

For example, in the context of TFSAs, proposed new subsection 146.2(6.2) may be introduced to address the IIAC's request:

> **146.2 (6.2)** If tax is payable under this Part for a taxation year because of subsection (6) by a trust that is governed by a TFSA that holds one or more properties that are non-qualified investments for the trust at

> any time in the taxation year, <u>and the issuer took reasonable steps to confirm the property or properties were qualified investments at the time the trust acquired the property or properties</u>, then:
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> > (a) the holder of the TFSA is jointly and severally, or solidarily, liable with the trust to pay each amount payable under this Act by the trust that is attributable to that property or those properties; and
> >
> > (b) the issuer's liability at any time for amounts payable under this Act in respect of that property or those properties shall not exceed the total of
> >
> > > (i) the amount of property of the trust that the issuer is in possession or control of at that time in its capacity as legal representative of the trust, and
> > >
> > > (ii) the total amount of all distributions of property from the trust on or after the date that the notice of assessment was sent in respect of the taxation year and before that time.

As part of the IIAC's proposed solution, the Tax Act will also need to be amended similarly for RRSPs, RRIFs, RESPs, RDSPs, FHSAs and DPSPs to include a provision substantively identical to the IIAC's proposed new subsection 146.2(6.2) for TFSAs (so that the issuers of those registered plans are similarly not liable for the registered plan's interest, penalties and taxes from holding non-QIs in certain circumstances).

The IIAC's suggestion for proposed new subsection 146.2(6.2) of the Tax Act is modelled after existing subsection 146.2(6.1). Existing subsection 146.2(6.1) of the Tax Act was introduced in 2019 to prevent registered plan issuers from being liable for the TFSA's interest, penalties and taxes owing from carrying on a business. The Department of Finance introduced subsection 146.2(6.1) of the Tax Act because it recognized that TFSA issuers had no control over the TFSA carrying on a business, since it was the TFSA holder's trading activities (rather than any activities of the TFSA issuer) that ultimately determine whether the TFSA is carrying on a business.[17] The IIAC submits that the current unfairness for registered plan issuers being liable for the registered plan's amounts arising from holding a non-QI in certain circumstances is analogous to the impetus that caused the Department of Finance to introduce subsection 146.2(6.1) of the Tax Act.

There is a deliberate drafting difference between existing subsection 146.2(6.1) of the Tax Act and the IIAC's proposed new subsection 146.2(6.2) of the Tax Act, which is in the underlined portion of the IIAC's proposed language (see above). As mentioned in this letter, the IIAC is only requesting to limit the liability of registered plan issuers in "appropriate circumstances". To be specific, the IIAC is only requesting relief for registered plan issuers in circumstances where the registered plan issuer took reasonable steps to determine whether the asset was a QI at the time the asset was acquired by the registered plan. "Reasonable steps" will naturally differ depending on the particular QI being

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[17] Investment Industry Association of Canada, "Request to Amend Income Tax Act Legislation and Administration to Ensure Tax Liability Borne Appropriately re Tax-Free Savings Accounts" (3 July 2014), online: https://iiac-accvm.ca/wp-content/uploads/IIAC-Letter-to-Finance-and-CRA-re-Carrying-on-a-Businesses-and-Borrowing-Within-TFSAs.pdf at 2-4.

considered. For example, the registered plan issuer should not be liable for any of the registered plan's interest, penalties or taxes from holding a non-QI if:

1. The asset is in actuality a non-QI, despite the registered plan issuer taking reasonable steps at the time of acquisition to (*incorrectly*) conclude that the asset is a QI (for example, this would prevent a registered plan issuer from being liable where the registered plan issuer took the reasonable step of obtaining a legal opinion that *incorrectly* concluded the shares are those of a "specified small business corporation"); or
2. The asset ceases to be a QI and becomes a non-QI while held by the registered plan (for example, this would prevent a registered plan issuer from being liable where the shares of a non-resident corporation become delisted and therefore a non-QI).

For greater certainty, the IIAC does not propose to provide a "blanket" limitation on the registered plan issuer's liability for the registered plan's interest, penalties and taxes arising from holding a non-QI. In particular, if the registered plan issuer does not take reasonable steps to determine whether the particular asset is a QI at the time it is acquired by the registered plan, then the registered plan issuer should continue to be liable for the registered plan's amounts owning.

## 3) Simplifying the Rules for Small Business Shares as QIs

### **Request:** Simplifying the Regime for Small Business Shares as QIs

The IIAC requests that the QI regime for shares of small businesses be simplified by:

1. Creating one set of rules for eligible registered plans on the requirements for small business shares to be QIs; and
2. Making the small business corporation responsible for determining the FMV of the shares on an annual basis.

### **Policy Rationales:** Why Should the Small Business Regime be Simplified?

#### Harmonizing the QI Rules for Small Business Shares

Under section 4900 of the Tax Regulations, shares of certain small business corporations can be QIs if the corporation is either:

1. A "specified small business corporation" (as defined in subsection 4901(2) of the Tax Regulations); or
2. An "eligible corporation" (as defined in subsection 4901(2) of the Tax Regulations).

Qualification of the small business corporation as a "specified small business corporation" is relevant for QIs in RRSPs, RRIFs, RESPs, TFSAs and FHSAs. On the other hand, qualification as an "eligible corporation" is only relevant for QIs in RRSPs, RRIFs and RESPs.

The CRA has acknowledged in Income Tax Folio S3-F10-C1 that the two foregoing tests are similar. As noted by the CRA in Income Tax Folio S3-F10-C1, the conditions for qualification as a QI for an "eligible corporation" are comparable to the conditions for a "specified small business corporation", except that the conditions must be satisfied not only at a point in time but also throughout the entire period the shares are held in the registered plan. This results in the requirements for the (less onerous) “specified small business corporation” being used instead of the (more onerous) “eligible corporation” requirements. Generally, any corporation that meets the requirements at the time of the acquisition and throughout the period of ownership under the “eligible corporation” test will also meet the requirements under the “specified small business corporation shares” test.

In light of the foregoing, the IIAC submits that the “eligible corporation” test is not required and creates unnecessary complications in the tax system. The existence of two tests (*i.e.,* “specified small business corporation” vs. “eligible corporation”) is unnecessary, particularly when both tests are aimed at the same policy objective and are generally identical in their application. These two different sets of rules create unnecessary complications within the tax system and for registered plan issuers trying to administer such tests.

To promote simplicity within the tax system, the two separate tests should be consolidated into one test for all of the registered plans that may hold shares of a small business corporation. In particular, the “specified small business corporation” should be the sole test for all registered plans that may hold shares of a small business (*i.e.,* RRSPs, RRIFs, RESPs, TFSAs and FHSAs). As the rules regarding “eligible corporations” are more restrictive and apply to less types of registered plans, it is logical to remove the “eligible corporation” rules and use only the rules pertaining to “specified small business corporations”. Furthermore, it is more preferable to solely use the “specified small business corporation” test because the concept of a “small business corporation” is used for other purposes of the Tax Act (such as for purposes of the lifetime capital gains exemption) – in other words, consistency in the key terms used in the Tax Act will also promote simplicity within the tax system.

### Small Business Corporation is Responsible for Determining FMV of Shares

Currently, there are various circumstances where a registered plan issuer is required to determine the FMV of the small business shares that are held within a registered plan.[18]

In order to complete a valuation for a company, the company’s management needs to be involved (since management needs to supply the key financial information and financial assumptions relating to the company which impacts the company’s valuation). While the registered plan issuer is required to determine the FMV of such shares, the registered plan issuer cannot compel management to engage a valuator. Similarly, the registered plan holder also likely has no ability to compel the company to complete a valuation of the shares since it has insufficient control over the affairs of the corporation (for example, a registered plan likely holds less than 10% of the voting shares of the corporation as a result of the prohibited investment rules in the Tax Act. Accordingly, neither the registered plan holder nor the registered plan issuer should be liable to provide the FMV information on the applicable registered plan tax slips, since neither of those persons can cause a valuation to be completed on the small business corporation.

[18] For instance, regulation 214(1.1) and Regulation 215(2.1) require the issuer of the RRSP and RRIF, respectively, to make an information return each calendar year containing the total fair market value of all property held in the registered plan at the end of the year. Other registered plans have annual FMV reporting requirements and FMV reporting requirements when there is a disposition.

Instead, it is the small business corporation that is in the best position to provide the valuation. From a fairness perspective, it also makes sense for the small business corporation to be liable for obtaining the valuations (including incurring the costs to obtain such valuations), since the small business corporation directly benefits from having access to registered plan investors as further sources of capital funding. While it makes sense for the small business corporation to be responsible for determining the valuation of the shares, there is currently not a mechanism to compel the small business corporation to provide the valuation to the registered plan holder (who then provides this to the registered plan issuer for tax slip purposes).

### **Proposed Solutions:** Legislative Changes

#### Harmonizing the QI Rules for Small Business Shares: "Specified Small Business Corporation" as the Sole Test

To promote simplicity in the tax system, the IIAC asks the Department of Finance to remove the "eligible corporation test" for QIs, so that only the "specified small business corporation" test remains.

#### Small Business Corporation is Responsible for Determining FMV of Shares

If a small business corporation issues shares to a registered plan as the subscriber of such shares, the Department of Finance should consider adding an obligation in the Tax Act for such corporation to provide the registered plan issuer or holder with an annual valuation of the shares held in the registered plan.

By ensuring the registered plan holder has this information, this allows registered plan issuers to have the FMV of the small business corporation shares for their tax compliance purposes.

## 4) Other Requests

### **Request:** Simplifying the Designated Stock Exchanges List for Multi-Tiered and Multi-Segmented Exchanges

Subsection 248(1) of the Tax Act defines a designated stock exchange as "a stock exchange, or that part of a stock exchange, for which a designation by the Minister of Finance under section 262 [of the Tax Act] is in effect".

Certain stock exchanges are multi-tiered, and in some cases, only certain tiers of such exchanges are qualified as a designated stock exchange. Where tiers are not identified on the designated stock exchange, the CRA has taken the administrative view that only the highest tier or main part of the exchange qualifies as a designated stock exchange. When a person acquires a security from a multi-tiered exchange, the particular tier of the exchange is not always obvious to the purchaser (for example, the trading platform used by the purchaser may not indicate the tier of the exchange that the security trades on).

In addition to the difficulties in the context of multi-tiered exchanges, there is also confusion in the context of multi-segmented exchanges. The Minister of Finance has qualified various exchanges in the European Union ("**EU**") that operate two market segments: (i) an official EU-regulated market and (ii) an unofficial market that is regulated by the exchange itself. The CRA takes the administrative position that the latter segment of such an exchange is <u>not</u> a designated stock exchange, even if the Minister of

Finance has designated the entire exchange as a designated stock exchange.[19] For example, even though the entire London Stock Exchange has been qualified as a designated stock exchange by the Minister of Finance,[20] the CRA takes the position that the Alternative Investment Market (the "AIM") of the London Stock Exchange is not a designated stock exchange because the AIM is only regulated by the exchange itself. Even if the foregoing CRA administrative position is correct at law, this unnecessarily complicates matters for taxpayers trying to determine whether or not they are purchasing securities listed on a designated stock exchange.

For the reasons explained above with the complexities and challenges associated with the application of the designated stock exchange list to multi-tiered and multi-segmented exchanges, the IIAC requests that the Department of Finance qualify all tiers and all segments of multi-tiered and multi-segmented exchanges to make the designated stock exchange rules easier to administer. Purchasers of securities should not have any doubts as to whether they are purchasing securities on a designated stock exchange, and under the current regime, there exists opportunity for doubt (as described in the scenarios above).

## Request: Treating All Derivatives Traded on Designated Stock Exchanges as QIs

Registered plans are generally able to invest in derivatives traded on a designated stock exchange in limited circumstances. In particular, paragraph (d) of the definition of "qualified investment" in section 204 of the Tax Act provides that a derivative that is traded on a designated stock exchange is a QI, so long as the holder's risk of loss in respect of the derivative may not exceed the holder's cost.

The IIAC requests that the Department of Finance consider eliminating the restrictions on when a registered plan may invest in derivatives. In particular, the IIAC requests the Department of Finance to permit registered plans to acquire any derivative that is traded on a designated stock exchange, regardless of the holder's risk of loss in respect of such derivative. There are already rules in the Tax Act that restrict a registered plan's ability to borrow, which should adequately address the Department of Finance's concerns with registered plans trading on margin.

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[19] Canada Revenue Agency, *Income Tax Folio* S3-F10-C1, "Qualified Investments – RRSPs, RESPs, RRIFs, RDSPs, FHSAs and TFSAs," (last modified 28 May 2024) online: https://www.canada.ca/en/revenue-agency/services/tax/technical-information/income-tax/income-tax-folios-index/series-3-property-investments-savings-plans/series-3-property-investments-savings-plan-folio-10-registered-plans-individuals/income-tax-folio-s3-f10-c1-qualified-investments-rrsps-resps-rrifs-rdsps-tfsas.html#toc5 at 1.19.
[20] Department of Finance, "Designated Stock Exchanges" (last modified 27 June 2024), online: https://www.canada.ca/en/department-finance/services/designated-stock-exchanges.html.

We would be pleased to discuss the foregoing with you at your earliest convenience.

Sincerely,

**THE INVESTMENT INDUSTRY ASSOCIATION OF CANADA (IIAC)**

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